In the Supreme Court of the United States

OCTOBER TERM, 1971

No. 71-1022

UNITED STATES OF AMERICA, PETITIONER,

v.

JAMES A. BASYE, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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RELEVANT DOCKET ENTRIES—DISTRICT COURT

(James A. Basye and Evelyn E. Basye v. United States, No. 44352)

Date	Filings—Proceedings
Nov. 12, 1965	Filed complaint and issued summons
Nov. 22, 1965	Filed summons, executed Nov. 15, 1965.
Jan. 13, 1966	Filed answer of U.S.A.
Mar. 16, 1966	Filed stip. & order consolidating actions Nos. 44352-3-4-5 & 6 for all purposes
May 8, 1967	Filed order consolidating actions & including No. 45575.
Mar. 27, 1968	Filed stipulation for presentation of cases as short cause under rules 7 & 9 and agreed statements of fact and issue
June 21, 1968	Ordered Court trial commenced, on stipulation of facts, after certa stipulations & arguments by counsel, ordered memos to be filed by July 22, 1968 for submission
July 15, 1968	Ordered these consolidated cases submitted
Aug. 5, 1968	Ordered case submitted
Nov. 29, 1968	Filed memo & order directing judgments for plaintiffs
Dec. 13, 1968	Entered judgment in favor of plaintiff in the amount of $3,669.95 filed Dec. 12, 1968 Mailed clerks notice of entry of judgment
Feb. 7, 1969	Filed defts. notice of appeal Mailed clerks notice of appeal
Apr. 24, 1969	Made, Mailed Record on Appeal CCA

(Jack J. Cook and Carol L. Cook v. United States, No. 44353)

Nov. 12, 1965	Filed complaint and issued summons
Nov. 22, 1965	Filed summons, executed Nov. 16, 1965.
Jan. 13, 1966	Filed answer of U.S.A.
Mar. 16, 1966	Filed stip. & order consolidating actions Nos. 44352-3-4-5 & 6 for all purposes. (In 44352)
May 8, 1967	Filed order consolidating actions & including action No. 45575. (In 44352)

Date	Filings—Proceedings
Mar. 27, 1968	Filed stipulation for presentation of cases as short cause under rules 7 & 9 and agreed statements of facts and issue (in 44352)
June 21, 1968	Ordered Court trial commenced, on stipulation of facts, after certa stipulations & arguments of counsel, ordered memos to be filed by July 22, 1968 and matter cont to July 29, 1968 for submission
Aug. 5, 1968	Ordered case submitted
Nov. 29, 1968	Filed memo & order directing judgment for pltfs (in 44352)
Dec. 13, 1968	Entered judgment in favor of pltf filed Dec. 12, 1968 in the amount of $358.39 Mailed clerks notice of entry of judgment
Feb. 7, 1969	Filed defts. notice of appeal Mailed clerks notice of filing of appeal.
Apr. 24, 1969	Made, Mailed Record on Appeal CCA

(Maurice C. Fishler and Phyllis H. Fishler v. United States, No. 44354)

Nov. 12, 1965	Filed complaint and issued summons
Nov. 22, 1965	Filed summons, executed Nov. 15, 1965.
Jan. 13, 1966	Filed answer of U.S.A.
Mar. 16, 1966	Filed stip. & order consolidating actions Nos. 44352-3-4-5 & 6 for all purposes. (In 44352)
May 8, 1967	Filed order consolidating actions & including action No. 45575. (In 44352)
Mar. 27, 1968	Filed stipulation for presentation of cases as short cause under rules 7 & 9 and agreed statements of facts and issue (in 44352)
June 21, 1968	Ordered Court trial commenced, on stipulation of facts, after certa stipulations & arguments by counsel, ordered memos to be filed by July 22, 1968 and matter cont to July 29, 1968 for submission
Aug. 5, 1968	Ordered case submitted
Nov. 29, 1968	Filed memo & order directing judgment for pltfs (in 44352)

Date	Filings—Proceedings
Dec. 13, 1968	Entered judgment filed Dec. 12, 1968 in favor of pltf in the amount of $1,861.74 Mailed clerks notice of entry of judgment
Feb. 7, 1969	Filed defts. notice of appeal Mailed clerks notice of filing of appeal.
Apr. 24, 1969	Made, Mailed Record on Appeal CCA

(Henry Donald Grant and Jean M. Grant v. United States, No. 44355)

Nov. 12, 1965	Filed complaint and issued summons
Nov. 22, 1965	Filed summons, executed Nov. 15, 1965.
Jan. 13, 1966	Filed answer of U.S.A.
Mar. 16, 1966	Filed stip. & order consolidating actions Nos. 44352-3-4-5 & 6 for all purposes. (In 44352)
May 8, 1967	Filed order consolidating actions & including action No. 45575. (In 44352)
Mar. 27, 1968	Filed stipulation for presentation of cases as short cause under rules 7 & 9 and agreed statements of facts and issue (in 43352)
June 21, 1968	Ordered Court trial commenced, on stipulation of facts, after certai stipulations & arguments by counsel, ordered memos to be filed by July 22, 1968 and matter cont to July 29, 1968 for submission
Aug. 5, 1968	Ordered case submitted
Nov. 29, 1968	Filed memo & order directing judgment for pltfs (in 44352)
Dec. 13, 1968	Entered judgment filed Dec. 12, 1968 in favor of pltf in the amount of $4,963.33 Mailed clerks notice of entry of judgment
Feb. 7, 1969	Filed defts. notice of appeal Mailed clerks notice of deft. filing appeal
Apr. 24, 1969	Made, Mailed Record on Appeal CCA

(William S. Hunter and Jessamine S. Hunter v. United States, No. 44356)

Nov. 12, 1965	Filed complaint and issued summons
Nov. 22, 1965	Filed summons, executed Nov. 15, 1965.
Jan. 13, 1966	Filed answer of U.S.A.

Date	Filings—Proceedings
Mar. 16, 1966	Filed stip. & order consolidating actions Nos. 44352-3-4-5 & 6 for all purposes. (In 44352)
May 8, 1967	Filed order consolidating actions & including action No. 45575. (In 44352)
Mar. 27, 1968	Filed stipulation for presentation of cases as short cause under rules 7 & 9 and agreed statements of facts and issue (in 44352)
June 21, 1968	Ordered Court trial commenced, on stipulation of facts, after cert stipulations & arguments by counsel, ordered memos to be filed by July 22, 1968 and matter cont to July 29, 1968 for submission
Aug. 5, 1968	Ordered case submitted
Nov. 29, 1968	Filed memo & order directing judgment for pltfs (in 44352)
Dec. 13, 1968	Entered judgment filed Dec. 12, 1968 in favor of pltf in the amount of $7,061.41 Mailed clerks notice of entry of judgment
Feb. 7, 1969	Filed defts. notice of appeal. Mailed clerks notice of deft. filing appeal.
Apr. 24, 1969	Made, Mailed Record on Appeal CCA
	(George W. Sorokowski and Nadia Sorokowski v. United States, No. 45575)
Aug. 26, 1966	Filed complaint, issued summons.
Aug. 30, 1966	Filed Demand for Jury Trial.
Sep. 28, 1966	Filed summons, exec. Aug. 26, 1966.
Oct. 24, 1966	Filed answer of U.S.A.
Mar. 9, 1967	Filed stip. withdrawing demand for jury trial.
May 1, 1967	Filed stip. & order granting leave for deft to file counterclaim by supplemental pleading
May 3, 1967	Filed counterclaim of defendant
May 8, 1967	Filed order consolidating actions Nos. 44352-3-4-5-6 and this action No. 45575 for all purposes.
May 12, 1967	Filed answer of pltffs. to counterclaim.

Date	Filings—Proceedings
Mar. 27, 1968	Filed stipulation for presentation of cases as short cause under rules 7 & 9 and agreed statements of facts and issue (in 44352)
June 21, 1968	Ordered Court trial commenced, on stipulation of facts, after certa stipulations & arguments by counsel, ordered memos to be filed by July 22, 1968 and matter cont to July 29, 1968 for submission
Aug. 5, 1968	Ordered case submitted
Nov. 29, 1968	Filed memo & order directing judgment for pltfs (in 44352)
Dec. 13, 1968	Entered judgment filed Dec. 12, 1968 in favor of pltf in the amount of $3,930.66 and a set off in favor of the deft U.S.A. in the amount of $3,875.31
	Mailed clerks notice of entry of judgment
Feb. 7, 1969	Filed defts. notice of appeal.
	Mailed clerks notice of deft. filing appeal.
Apr. 24, 1969	Made, Mailed Record on Appeal CCA

RELEVANT DOCKET ENTRIES—COURT OF APPEALS

(Nos. 24170, 24171, 24172, 24173, 24174, 24175.)

Date	Filings—Proceedings
May 13, 1969	FILED order (C) granting stip. to consolidate appeals #24170-24175
Apr. 16, 1971	ARGUED AND SUBMITTED (M[Merrill D[Duniway] Hu[Hufstedler])
Sep. 16, 1971	ORDERED OPINION (DUNIWAY) FILED & JUDG TO BE FILED & ENTD
Sep. 16, 1971	Filed opinion Affirmed (see entry of 11/23)
Sep. 16, 1971	Filed & Entered Judgment
Sep. 29, 1971	FILED 6 ORIG & 24 COPIES APPELLEES' PETITION FOR REHEARING
Nov. 23, 1971	Filed order (M D Hu) modifying opinion of 9/16; further ordered that petition for rehearing be denied
Dec. 1, 1971	ISSUED JUDGMENT TO CLERK OF DISTRICT COURT
Feb. 14, 1972	Rcvd SC notice of filing of pet for writ of certiorari (SC# 71-1022)

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF CALIFORNIA
SOUTHERN DIVISION

JAMES A. BASYE and EVELYN E. BASYE, PLAINTIFFS, vs. UNITED STATES OF AMERICA, DEFENDANT.	Civil No. 44352 Complaint for Refund of Internal Revenue Taxes

Plaintiffs allege:

FIRST CAUSE OF ACTION

I.

Plaintiffs are citizens of the United States and reside in the County of Alameda, in the Southern Division of the Northern District of California. This Court has jurisdiction and venue of this action for refund of Internal Revenue Taxes overpaid under Title 26, U.S.C. § 7422, Title 28, U.S.C. §§ 1346(a)(1), 1402(a)(1), and the Internal Revenue Laws of the United States of America.

II.

On or about April 15, 1961, plaintiffs filed with defendant their federal income tax return for the year 1960 showing tax due thereon in the amount of $7,891.51. Plaintiffs paid the tax as shown on said income tax return on or before April 15, 1961.

III.

On or about April 13, 1965, defendant illegally and erroneously assessed against plaintiffs as an alleged deficiency of income tax the sum of $1,424.02, together with interest thereon of $356.70.

IV.

On or about June 18, 1965, defendant illegally and erroneously collected the aforesaid deficiency in tax from plaintiffs.

V.

On or about July 8, 1965, plaintiffs filed a claim for refund of tax overpaid, in the amount hereinabove set forth, plus interest thereon. A copy of said refund claim is attached hereto as Exhibit "A" and is by this reference incorporated herein. On or about October 12, 1965, notice of disallowance of said claim for refund was issued by defendant.

VI.

Plaintiffs have overpaid their income tax for the year 1960 in the amount of $1,424.02 in tax, plus $356.70 in interest.

VII.

No portion of said overpayment of tax and interest has been refunded by defendant to plaintiffs, and no legal offsets or credits exist with respect thereto.

VIII.

Defendant is indebted to plaintiffs in the sum set forth in paragraph VI above, together with interest on said sum from the date of overpayment, on or about June 18, 1965, according to law.

WHEREFORE, plaintiffs demand judgment against defendant for the sum of $1,780.72, together with interest provided by law, and costs.

SECOND CAUSE OF ACTION

I.

Plaintiffs incorporate herein by reference paragraph I of their First Cause of Action.

II.

On or about April 15, 1962, plaintiffs filed with defendant their federal income tax return for the year 1961 showing tax due thereon in the amount of $8,706.00. Plaintiffs paid the tax as shown on said income tax return on or before April 15, 1962.

III.

On or about April 13, 1965, defendant illegally and erroneously assessed against plaintiffs as an alleged deficiency of income tax the sum of $1,586.93, together with interest thereon of $302.30.

IV.

On or about June 18, 1965, defendant illegally and erroneously collected the aforesaid deficiency in tax from plaintiffs.

V.

On or about July 8, 1965, plaintiffs filed a claim for refund of tax overpaid, in the amount hereinabove set forth, plus interest thereon. A copy of said refund claim is attached hereto as Exhibit "B" and is by this reference incorporated herein. On or about October 12, 1965, notice of disallowance of said claim for refund was issued by defendant.

VI.

Plaintiffs have overpaid their income tax for the year 1961 in the amount of $1,586.93 in tax, plus $302.30 in interest.

VII.

No portion of said overpayment of tax and interest has been refunded by defendant to plaintiffs, and no legal offsets or credits exist with respect thereto.

VIII.

Defendant is indebted to plaintiffs in the sum set forth in paragraph VI above, together with interest on said sum from the date of overpayment, on or about June 18, 1965, according to law.

WHEREFORE, plaintiffs demand judgment against defendant for the sum of $1,889.23, together with interest provided by law, and costs.

Dated: Nov. 12, 1965

STARK & CHAMPLIN
By John F. Banker
[JOHN F. BANKER]
Attorneys for Plaintiffs

Form 843
(Rev. May 1960)

U. S. TREASURY DEPARTMENT - INTERNAL REVENUE SERVICE

CLAIM

TO BE FILED WITH THE DISTRICT DIRECTOR WHERE ASSESSMENT WAS MADE OR TAX PAID

District Director's Stamp (Date received)

The District Director will indicate in the block below the kind of claim filed, and fill in, unless required.

- [X] Refund of Taxes Illegally, Erroneously, or Excessively Collected.
- [ ] Refund of Amount Paid for Stamps Unused, or Used in Error or Excess.
- [ ] Abatement of Tax Assessed (not applicable to estate, gift, or income taxes).

PLEASE TYPE OR PRINT PLAINLY

Name of taxpayer or purchaser of stamps

Dr. James A. Baeve and Mrs. Evelyn Baeve

Number and street

6114 Oceanview Drive

City, town, postal zone, State

Oakland, California 94618

Fill in applicable blanks.—Attach letter when space is not sufficient

1. Social security number(s)

560 - 28 - 7480 554 - 36 - 5547

2. If an employer, state employer identification number

---

3. District or stock stamps (if any) are filed

San Francisco

4. Name and address shown on return, if different from above

Same

5. Period—if tax reported on annual basis, prepare separate claim for each taxable year

From January 1, 1960, To December 31, 1960

6. Kind of tax

Income

7. Amount claimed

$ 1,424.02 Tax
$ 356.90 Interest

Date of payment

June 18, 1965

8. Date stamps were purchased from Government office

9. Amount to be refunded

$1,780.92

10. Amount to be abated (not applicable to income, estate, or gift taxes)

$

11. The reason believed that this claim should be allowed for the following reasons:

See Attached

I declare under the penalties of perjury that this claim (including any accompanying schedules and statements) has been examined by me and to the best of my knowledge and belief is true and correct.

Signed Leonard Mercussen

Dated JUL 8 1965, 19__

Signature of Attorney

Title, if any

INSTRUCTIONS

1. The claim must set forth in detail each ground upon which it is made and facts sufficient to apprise the Commissioner of the exact basis thereof.

2. If a joint income tax return was filed for the year for which this claim is filed, enter social security and employer identification numbers, if any, of both husband and wife and both must sign this claim even though only one had income.

3. Whenever it is necessary to have this claim signed by an agent on behalf of the taxpayer, an authenticated copy of the document (usually authorizing such agent to sign the claim on behalf of the taxpayer) shall accompany the claim.

4. If a return is filed by an individual and a refund claim is thereafter filed by a legal representative of the deceased, certified copies of the letters testamentary, letters of administration, or other similar evidence must be annexed to the claim, to show the authority of the executor, administrator, or other fiduciary by whom the claim is filed. If an executor, administrator, guardian, trustee, receiver, or other fiduciary files a claim and a refund check is filed in the name fiduciary, documentary evidence to establish the legal authority of the fiduciary must also accompany the claim, provided a statement is made on the claim showing that the refund check was filed by the fiduciary and that the latter is still acting.

5. Where the taxpayer is a corporation, the claim will be signed with the corporate name, followed by the signature and title of the officer having authority to sign for the corporation.

6. If claim is for excess social security (F.I.C.A.) tax withheld as a result of having had more than one employer, include the name and addresses of your employers, and the amount of wages received and taxes withheld by each as part of your employment in item 11. Do not claim tax withheld if you have obtained the refund establishing on your individual income tax return.

Form 843 (Rev. 5-60)

11. The Commissioner of Internal Revenue assessed an income tax deficiency of $1,424.02 for the year 1960 and an income tax deficiency of $1,586.93 for the year 1961 against taxpayers Dr. James A. Basye and Mrs. Evelyn E. Basye. The basis of the deficiency assessments was set forth in the statement attached to Form L-21A, dated April 13, 1965. A copy of that statement is attached hereto as Exhibit "A". Taxpayers paid these assessments, together with interest in the amount of $659.00, on June 18, 1965.

A summary of the facts upon which this claim is based is as follows:

Taxpayer James A. Basye was a participant in the Retirement Plan for the Permanente Medical Group. Said Retirement Plan was established July 1, 1959, as the result of negotiations between two independent organizations, Kaiser Foundation Health Plan, Inc., a California nonprofit corporation (hereinafter called "Health Plan"), on the one hand, and The Permanente Medical Group, a partnership of physicians, and its affiliate, the DeKruif, Echardt, Mott, Rubin, Stricker Group (hereinafter collectively called "Medical Group"), on the other hand. Said Retirement Plan was not established by Medical Group alone, nor for its benefit alone, but was established in good faith to serve the independent, and in some respects conflicting interests of Health Plan, Medical Group and the participating physicians.

Pursuant to said Retirement Plan, a trust was established to which Health Plan made certain contributions. No contributions were made to the trust by Medical Group (by either the Permanente Medical Group or its affiliated group, the DeKruif, Echardt, Mott, Rubin, Stricker Group). Individual participating physicians may become entitled to retirement benefits from said trust upon fulfilling certain conditions. Such individual physicians are the only beneficiaries of said trust, and Medical Group has no right, either present or prospective, in the funds contributed by Health Plan to the trust. No income in cash or its equivalent was actually or constructively received by Medical Group, nor was any sum properly accruable to Medical Group, nor did Medical Group receive or realize income in any manner or form, as the result of contributions by Health Plan to the trust.

Taxpayers' returns for 1960 and 1961 reported income on the cash receipts and disbursements basis. Taxpayer

James A. Basye had no right to receive any money or other benefits from the trust during the years 1960 and 1961; his expectancy of future benefits under said Retirement Plan was dependent upon fulfilling certain conditions precedent, and was subject to forfeiture upon the happening of various contingencies. No income in cash or its equivalent was actually or constructively received by taxpayers from the trust, or otherwise, nor did taxpayers receive or realize income in any manner or form as a result of Dr. Basye's participation in the Retirement Plan.

Copies of the documents supporting the foregoing factual summary have been furnished to the Internal Revenue Service. Additional copies will be furnished on request.

Taxpayers claim this refund on the grounds that the partnership of which Dr. Basye was a member did not receive nor realize income in any manner or form as a result of the establishment of said Retirement Plan nor as a result of any payments to the trust; that no part of the payments to said trust were accruable to the partnership; that the gross income as reported on taxpayers' return is correct and that the Commissioner's adjustments to their returns as set forth in Exhibit "A" is erroneous.

Taxpayers claim this refund on the further ground that Dr. Basye did not realize any income during 1959 as an individual participant in said Retirement Plan, because neither cash nor its equivalent was actually or constructively received by him, nor did he receive or realize income in any manner or form as a result of his participation in the Retirement Plan.

U. S. TREASURY DEPARTMENT
INTERNAL REVENUE SERVICE
OFFICE OF REGIONAL COMMISSIONER

Appellate Division
447 Sutter Street, Room 301
San Francisco, California 94103

(Illegible) APR 13, 1965

In Reply Refer To
(Illegible)
Ap:SF:AS:CFS

TAXABLE YEAR ENDED	DEFICIENCY
Dec. 31, 1960	$1,424.02
Dec. 31, 1961	1,586.93

Dr. James A. Basye and
Mrs. Evelyn E. Basye
Husband and Wife
6114 Oceanview Drive
Oakland, California

Dear Dr. and Mrs. Basye:

In accordance with the provisions of existing internal revenue laws, notice is given that the determination of your income tax liability for the above-noted taxable year(s) discloses a deficiency (or deficiencies) in the amount(s) shown above. The attached statement shows the computation of the deficiency or deficiencies.

IF YOU AGREE to this determination, please sign the enclosed agreement, Form 870, and return it promptly to this office. An addressed envelope is enclosed for this purpose. The signing and filing of this agreement will permit an early assessment of the deficiency or deficiencies and will limit the accumulation of interest.

IF YOU DO NOT AGREE, and do not sign and return the enclosed form, the deficiency or deficiencies will be assessed

for collection, as required by law, upon the expiration of ninety days from the date of this letter, unless within that time you contest this determination in the Tax Court of the United States by filing a petition with that Court in accordance with its rules, a copy of which may be obtained by writing to its Clerk, Box 70, Washington, D. C. 20044.

Very truly yours,
SHELDON S. COHEN
Commissioner

By (Signed) Edward P. Lee
Associate Chief
Appellate Division

STATEMENT

Ap:SF:AS:CFS
90-D:HVS

Dr. James A. Basye and
Mrs. Evelyn E. Basye
Husband and Wife
6114 Oceanview Drive
Oakland, California

Tax Liability for Taxable Years Ended
December 31, 1960 and December 31, 1961

INCOME TAX

Year	Deficiency
1960	$1,424.02
1961	1,586.93
Total	$3,010.95

Copies of this letter and statement have been mailed to your representatives, Mr. Leonard Marcussen, 1924 Broadway, 6th Floor, Oakland, California, and Stark & Champlin, 1100 Financial Center Building, Oakland, California 94612, in accordance with the authority contained in the power of attorney executed by you.

Taxable Year Ended December 31, 1960

ADJUSTMENTS TO INCOME

Taxable income as disclosed by return		$26,538.40
Unallowable deductions and additional income:		
(a) Partnership income	$3,076.22	
(b) Meals on duty	78.00	3,154.22
Taxable income as revised		$29,692.62

Taxable Year Ended December 31, 1960

EXPLANATION OF ADJUSTMENTS

(a) Examination of the books and records of the partnership, The Permanente Medical Group, discloses that your

distributive share of the corrected partnership ordinary net income of $6,254,210.54 for the fiscal year ended June 30, 1960 and taxable in your calendar year 1960 income tax return is $34,913.91 (see Exhibit A attached). Since you reported $31,837.69, your taxable income is increased by the difference in the amount of $3,076.22.

(b) The deduction of $78.00 claimed for meals is disallowed for the reason that you have not established that this amount constitutes an ordinary and necessary business expense.

Taxable Year Ended December 31, 1960

COMPUTATION OF INCOME TAX

Taxable income	$29,692.62
Income tax liability	$ 9,315.53
Income tax liability disclosed by original return, Document Locator No. 446019522	7,891.51
Deficiency in income tax	$ 1,424.02

Taxable Year Ended December 31, 1961

ADJUSTMENTS TO INCOME

Taxable income as disclosed by return		$28,396.00
Unallowable deductions and additional income:		
(a) Partnership income	$3,298.18	
(b) Meals on duty	78.00	3,376.18
Taxable income as revised		$31,772.18

Taxable Year Ended December 31, 1961

EXPLANATION OF ADJUSTMENTS

(a) Examination of the books and records of the partnership, The Permanente Medical Group, discloses that your distributive share of the corrected partnership ordinary net income of $7,400,581.69 for the fiscal year ended June 30, 1961 and taxable in your calendar year 1961 income tax return is $37,250.18 (see Exhibit B attached). Since you reported $33,952.00, your taxable income is increased by the difference of $3,298.18.

(b) The deduction of $78.00 claimed for meals is disallowed for the reason that you have not established that this amount constitutes an ordinary and necessary business expense.

Taxable Year Ended December 31, 1961

COMPUTATION OF INCOME TAX

Taxable income	$31,772.18
Income tax liability	$10,292.93
Income tax liability disclosed by Original return, Document Locator No.	8,706.00
Deficiency in income tax	$ 1,586.93

The Permanente Medical Group (a Partnership)
Year Ended June 30, 1960

Adjustments to Income

Ordinary income reported in return		$5,735,752.42
Adjustments:		
(a) Payments into trust fund for benefit of partnership	$516,298.38	
(b) Interest income from trust fund	2,159.74	518,458.12
Ordinary income as revised		$6,254,210.54

Explanation of Adjustments

(a) and (b) It has been determined that the payments made by Kaiser Foundation Health Plan, Inc., a California non-profit corporation, into the Trust Fund for the Retirement Plan of The Permanente Medical Group, a partnership, and the interest earned on the funds held by the trustee are income to the partnership. These payments into the Trust Fund are part of the basic compensation paid to The Permanente Medical Group for medical services performed as provided for in the Medical Service Agreement entered into by Kaiser Foundation Health Plan, Inc., and Permanente Medical Group.

Distribution of Income

Name of Partner	Ordinary Income
Basye, James A.	$ 34,913.91
Fishler, Maurice C.	29,144.25
Grant, Henry Donald	38,059.05
Hunter, Jessamine S.	22,435.64
Hunter, William S.	29,501.81
Other partners	6,100,155.88
Total	$6,254,210.54

The Permanente Medical Group (a Partnership)

Year Ended June 30, 1961

Adjustments to Income

Ordinary income reported in return		$6,823,301.30
Adjustments:		
(a) Payments into trust fund for benefit of partnership	$573,924.60	
(b) Interest income from trust fund.	3,355.79	577,280.39
Ordinary income as revised		$7,400,581.69

Explanation of Adjustments

(a) and (b) See explanation of adjustment (a) for the year ended June 30, 1960.

Distribution of Income

Name of Partner	Ordinary Income
Basye, James A.	$ 37,250.18
Lynn, Carol (Carol Cook)	19,155.84
Grant, Henry Donald	41,496.80
Fishler, Maurice C.	31,055.26
Hunter, Jessamine S.	25,537.51
Hunter, William S.	32,207.64
Other Partners	7,213,878.46
Total	$7,400,581.69

Form 2848
(Rev. March 1964)

U.S. Treasury Department - Internal Revenue Service

GENERAL POWER OF ATTORNEY

(CAUTION: Please read instructions on reverse before completing this form)

Know ye, I (address of principal)

James A. and Evelyn E. Basye
6114 Oceanview Drive
Oakland, California

hereby appoint(s) (Name and address of appointee(s))

Leonard Marcusson, 1924 Broadway - 6th Floor, Oakland, California;
Franklin C. Stark, Stanley E. Sparrowe and John F. Wells of
Financial Center Building, Oakland, California

as attorney(s)-in-fact to represent the principal(s) before any office of the Internal Revenue Service with respect to (specify Internal Revenue tax matter(s) and period or periods)

Income tax matter for years 1960 through 1963

Said attorney(s)-in-fact shall, subject to revocation, have full power to perform any and all acts that the principal(s) can perform, including the power to receive (but not to endorse and collect) checks in payment of any refund of Internal Revenue taxes, penalties, or interest, to delegate authority or to substitute another attorney or agent; to execute waivers of restrictions on assessment or collection of deficiencies or limits to execute consents extending the statutory period for assessment or collection of taxes; to execute a closing agreement (under section 7121 of the Internal Revenue Code) in respect of a tax liability or a specific matter; and to execute a protest to a determination of taxes by a district director.

Copies of correspondence addressed to the taxpayer in proceedings involving the above matter(s) should be sent to:

Leonard Marcusson, 1924 Broadway - 6th Floor, Oakland, California
Stark & Champlin, 1100 Financial Center Building, Oakland, California 94612

Any prior powers of attorney filed with this office by the principal(s) relating to the matter(s) and the year(s) or period(s) specified above are hereby revoked.

SIGNATURE OF PRINCIPAL IF INDIVIDUAL OR HUSBAND AND WIFE

Signature of Principal	Date	Signature of Principal	Date
James A. Basye	12-22-64	Evelyn E. Basye	12/22/64

SIGNATURE OF PRINCIPAL IF PARTNERSHIP, ESTATE, CORPORATION, ETC.

I/We (or members of principal) declare that I have the authority to execute this power of attorney on behalf of the principal.

Signature of Principal	Title	Date
Signature of Principal	Title	Date

CORPORATE SEAL (If applicable)

NOTARIZATION OR WITNESSING

The above-named principal signing on or for the principal(s) appeared before me and acknowledged this power of attorney and declared that he/she executed it as his/her/their free act and deed.

Signature of Notary: Dorothy Mathes
Name of Notary (Typed): DOROTHY MATHES
Date: 12-22-64
Notary Public in and for the State of California - Principal Office in Alameda County
My Commission Expires June 13, 1967
1541 West Manchester Blvd., Inglewood, Calif.

This power of attorney was signed by or for the principal(s) by a person or persons known to, and in the presence of, the two declarant witnesses whose signatures appear below.

Signature of Witness	Date
Signature of Witness	Date

CERTIFICATION BY ENROLLED ATTORNEY OR AGENT IN LIEU OF WITNESSING OR NOTARIZATION

I certify that I am in good standing and eligible to practice before the Internal Revenue Service (the following is applicable only if the principal is other than an individual or husband and wife) that to the best of my knowledge and belief, the person(s) signing above has/have the authority to execute this power of attorney on behalf of the principal.

Signature of Attorney-in-Fact	Enrollment Card Number	Expiration Date of Card

Form 2848 (Rev.)

Form 843
(Rev. Dec. 1954)

U.S. TREASURY DEPARTMENT - INTERNAL REVENUE SERVICE

CLAIM

TO BE FILED WITH THE DISTRICT DIRECTOR WHERE ASSESSMENT WAS MADE OR TAX PAID

District Director's Stamp
(Date received)

The District Director will indicate in the blank below the kind of claim filed, and fill in, where required.

- [x] Refund of Taxes Illegally, Erroneously, or Excessively Collected.
- [ ] Refund of Amount Paid for Stamps Unused, or Used in Error or Excess.
- [ ] Abatement of Tax Assessed (not applicable to estate, gift, or income taxes).

PLEASE TYPE OR PRINT PLAINLY

Name of taxpayer or purchaser of stamps

Dr. James A. Beavs and Mrs. Evelyn E. Beavs

Number and street

4114 Oceanview Drive

City, town, postal zone, State

Oakland, California 94618

Fill in applicable blanks. Attach letter when claimant is not taxpayer.

1. Social security number

360 - 28 - 7480

2. If an employee, enter employer identification number

3. District in which return was filed

San Francisco

4. Where and when shown on return, if different from above

Same

5. Period for which assessed or taxes paid, if proper return form for such taxable year

From January 1, 1941, to December 31, 1941

6. Kind of tax

Income

7. Amount assessed

$ 2,568.92 Tax
$ 102.30 Interest

8. Date payment was made

June 18, 1945

9. Date stamps were purchased from Government

10. Amount to be refunded

$ 1,889.33

11. Amount to be abated (not applicable to income, estate, or gift taxes)

$

12. The ground relied upon for the claim should be allowed by the following statute:

See Attached

I declare under the penalties of perjury that this claim (including any accompanying schedules and statements) has been examined by me and to the best of my knowledge and belief is true and correct.

Signature: Leonard Marcusson

Signature: Franklin C. Stark

Dated: JUL 8 1955, 19

Signature (Corporate officer, partner, or agent)

Signature (Corporate officer, partner, or agent)

INSTRUCTIONS

1. This claim must set forth in detail each ground upon which it is made and facts sufficient to apprise the Commissioner of the exact basis thereof.

2. If a joint income tax return was filed for the year for which this claim is filed, husband and wife should each sign this claim. In the case of husband and wife filing a joint return, this claim must be signed by both husband and wife even though only one had income.

3. Whenever it is necessary to have this claim executed by an agent on behalf of the taxpayer, an executed copy of the power of attorney authorizing such agent to sign the claim on behalf of the taxpayer should be filed with the claim.

4. If a refund is filed by an individual and a refund check is to be issued filed by a legal representative of the deceased, certified copies of the letters testamentary, letters of administration, or other similar evidence must be presented to the claim. Where the authority of the trustee, administrator, guardian, trustee, receiver, or other fiduciary filing the claim is filed. If an executor, administrator, guardian, trustee, receiver, or other fiduciary files a claim for refund of taxes illegally collected from the estate of a deceased taxpayer, documentary evidence to establish the legal authority of the fiduciary must also accompany the claim, unless such evidence is made on the face showing that the claim was filed by the fiduciary and that the estate is still acting.

5. Where the taxpayer is a corporation, the claim will be signed with the corporate name, followed by the signature and title of the officer having authority to sign for the corporation.

6. If claim is for excess profits tax (E.P.C.A.) tax refunded as a result of having had such items and conditions, include the amount and nature of your conference, and the amount of wages received and taxes withheld by each as paid of your employees filed in Item 11. Do not claim the refund if you have claimed the excess refunding the your individual income tax return.

Form 843 (Rev. 7-55)

11. The Commissioner of Internal Revenue assessed an income tax deficiency of $1,424.02 for the year 1960 and an income tax deficiency of $1,586.93 for the year 1961 against taxpayers Dr. James A. Basye and Mrs. Evelyn E. Basye. The basis of the deficiency assessments was set forth in the statement attached to Form L-21A, dated April 13, 1965. A copy of that statement is attached hereto as Exhibit "A." Taxpayers paid these assessments, together with interest in the amount of $659.00, on June 18, 1965.

A summary of the facts upon which this claim is based is as follows:

Taxpayer James A. Basye was a participant in the Retirement Plan for the Permanente Medical Group. Said Retirement Plan was established July 1, 1959, as the result of negotiations between two independent organizations, Kaiser Foundation Health Plan, Inc., a California nonprofit corporation (hereinafter called "Health Plan"), on the one hand, and The Permanente Medical Group, a partnership of physicians, and its affiliate, the DeKruif, Echardt, Mott, Rubin, Stricker Group (hereinafter collectively called "Medical Group"), on the other hand. Said Retirement Plan was not established by Medical Group alone, nor for its benefit alone, but was established in good faith to serve the independent, and in some respects conflicting interests of Health Plan, Medical Group and the participating physicians.

Pursuant to said Retirement Plan, a trust was established to which Health Plan made certain contributions. No contributions were made to the trust by Medical Group (by either the Permanente Medical Group or its affiliated group, the DeKruif, Echardt, Mott, Rubin, Stricker Group). Individual participating physicians may become entitled to retirement benefits from said trust upon fulfilling certain conditions. Such individual physicians are the only beneficiaries of said trust, and Medical Group has no right, either present or prospective, in the funds contributed by Health Plan to the trust. No income in cash or its equivalent was actually or constructively received by Medical Group, nor was any sum properly accruable to Medical Group, nor did Medical Group receive or realize income in any manner or form, as the result of contributions by Health Plan to the trust.

Taxpayers' returns for 1960 and 1961 reported income

on the cash receipts and disbursements basis. Taxpayer James A. Basye had no right to receive any money or other benefits from the trust during the years 1960 and 1961; his expectancy of future benefits under said Retirement Plan was dependent upon fulfilling certain conditions precedent, and was subject to forfeiture upon the happening of various contingencies. No income in cash or its equivalent was actually or constructively received by taxpayers from the trust, or otherwise, nor did taxpayers receive or realize income in any manner or form as a result of Dr. Basye's participation in the Retirement Plan.

Copies of the documents supporting the foregoing factual summary have been furnished to the Internal Revenue Service. Additional copies will be furnished on request.

Taxpayers claim this refund on the grounds that the partnership of which Dr. Basye was a member did not receive nor realize income in any manner or form as a result of the establishment of said Retirement Plan nor as a result of any payments to the trust; that no part of the payments to said trust were accruable to the partnership; that the gross income as reported on taxpayers' return is correct and that the Commissioner's adjustments to their returns as set forth in Exhibit "A" is erroneous.

Taxpayers claim this refund on the further ground that Dr. Basye did not realize any income during 1959 as an individual participant in said Retirement Plan, because neither cash nor its equivalent was actually or constructively received by him, nor did he receive or realize income in any manner or form as a result of his participation in the Reitrement Plan.

U.S. TREASURY DEPARTMENT

INTERNAL REVENUE SERVICE

OFFICE OF REGIONAL COMMISSIONER

Appellate Division
447 Sutter Street, Room 301
San Francisco, California 94103

Apr 13, 1965

In Reply Refer to
(Illegible)
AP:SF:AS:CFS

(Illegible)

Dr. James A. Basye and Mrs. Evelyn E. Basye Husband and Wife 6114 Oceanview Drive Oakland, California	Taxable Year Ended	Deficiency
	Dec. 31, 1960	$1,424.02
	Dec. 31, 1961	1,586.93

Dear Dr. and Mrs. Basye:

In accordance with the provisions of existing internal revenue laws, notice is given that the determination of your income tax liability for the above-noted taxable year(s) discloses a deficiency (or deficiencies) in the amount(s) shown above. The attached statement shows the computation of the deficiency or deficiencies.

IF YOU AGREE to this determination, please sign the enclosed agreement, Form 870, and return it promptly to this office. An addressed envelope is enclosed for this purpose. The signing and filing of this agreement will permit an early assessment of the deficiency or deficiencies and will limit the accumulation of interest.

IF YOU DO NOT AGREE, and do not sign and return the enclosed form, the deficiency or defiencies will be assessed for collection, as required by law, upon the expiration of ninety days from the date of this letter, unless within that time you contest this determination in the Tax Court of the United States by filing a petition with that Court in accordance with its rules, a copy of which may be

obtained by writing to its Clerk, Box 70, Washington, D.C. 20044.

Very truly yours,

SHELDON S. COHEN
Commissioner

By (Signed) Edward P. Lee
Associate Chief
Appellate Division

Ap:SF:AS:CFS
90-D:HVS

Dr. James A. Basye and
Mrs. Evelyn E. Basye
Husband and Wife
6114 Oceanview Drive
Oakland, California

Tax Liability for Taxable Years Ended
December 31, 1960 and December 31, 1961

INCOME TAX

Year	Deficiency
1960	$1,424.02
1961	1,586.93
Total	$3,010.95

Copies of this letter and statement have been mailed to your representatives, Mr. Leonard Marcussen, 1924 Broadway, 6th Floor, Oakland, California, and Stark & Champlin, 1100 Financial Center Building, Oakland, California 94612, in accordance with the authority contained in the power of attorney executed by you.

Taxable Year Ended December 31, 1960

ADJUSTMENTS TO INCOME

Taxable income as disclosed by return		$26,538.40
Unallowable deductions and additional income:		
(a) Partnership income	$3,076.22	
(b) Meals on duty	78.00	3,154.22
Taxable income as revised		$29,692.62

Taxable Year Ended December 31, 1960

EXPLANATION OF ADJUSTMENTS

(a) Examination of the books and records of the partnership, The Permanente Medical Group, discloses that your distributive share of the corrected partnership or-

dinary net income of $6,254,210.54 for the fiscal year ended June 30, 1960 and taxable in your calendar year 1960 income tax return is $34,913.91 (see Exhibit A attached). Since you reported $31,837.69, your taxable income is increased by the difference in the amount of $3,076.22.

(b) The deduction of $78.00 claimed for meals is disallowed for the reason that you have not established that this amount constitutes an ordinary and necessary business expense.

Taxable Year Ended December 31, 1960

COMPUTATION OF INCOME TAX

Taxable income	$29,692.62
Income tax liability	$ 9,315.53
Income tax liability disclosed by original return, Document Locator No. 446019522	7,891.51
Deficiency in income tax	$ 1,424.02

Taxable Year Ended December 31, 1961

ADJUSTMENTS TO INCOME

Taxable income as disclosed by return		$28,396.00
Unallowable deductions and additional income:		
(a) Partnership income	$3,298.18	
(b) Meals on duty	78.00	3,376.18
Taxable income as revised		$31,772.18

Taxable Year Ended December 31, 1961

EXPLANATION OF ADJUSTMENTS

(a) Examination of the books and records of the partnership, The Permanente Medical Group, discloses that your distributive share of the corrected partnership ordinary net income of $7,400,581.69 for the fiscal year ended June 30, 1961 and taxable in your calendar year 1961 income tax return is $37,250.18 (see Exhibit B attached). Since you reported $33,952.00, your taxable income is increased by the difference of $3,298.18.

(b) The deduction of $78.00 claimed for meals is disallowed for the reason that you have not established that

this amount constitutes an ordinary and necessary business expense.

Taxable Year Ended December 31, 1961

Computation of Income Tax

Taxable income	$31,772.18
Income tax liability	$10,292.93
Income tax liability disclosed by Original return, Document Locator No.	8,706.00
Deficiency in income tax	$ 1,586.93

EXHIBIT A

The Permanente Medical Group (a Partnership)
Year Ended June 30, 1960

ADJUSTMENTS TO INCOME

Ordinary income reported in return		$5,735,752.42
Adjustments:		
(a) Payments into trust fund for benefit of partnership	$516,298.38	
(b) Interest income from trust fund	2,159.74	518,458.12
Ordinary income as revised		$6,254,210.54

EXPLANATION OF ADJUSTMENTS

(a) and (b) It has been determined that the payments made by Kaiser Foundation Health Plan, Inc., a California non-profit corporation, into the Trust Fund for the Retirement Plan of The Permanente Medical Group, a partnership, and the interest earned on the funds held by the trustee are Income to the partnership. These payments into the Trust Fund are part of the basic compensation paid to The Permanente Medical Group for medical services performed as provided for in the Medical Service Agreement entered into by Kaiser Foundation Health Plan, Inc., and Permanente Medical Group.

DISTRIBUTION OF INCOME

Name of Partner	Ordinary Income
Basye, James A.	$ 34,913.91
Fishler, Maurice C.	29,144.25
Grant, Henry Donald	38,059.05
Hunter, Jessamine S.	22,435.64
Hunter, William S.	29,501.81
Other partners	6,100,155.88
Total	$6,254,210.54

The Permanente Medical Group (a Partnership)
Year Ended June 30, 1961

ADJUSTMENTS TO INCOME

Ordinary income reported in return		$6,823,301.30
Adjustments:		
(a) Payments into trust fund for benefit of partnership	$573,924.60	
(b) Interest income from trust fund	3,355.79	577,280.39
Ordinary income as revised		$7,400,581.69

EXPLANATION OF ADJUSTMENTS

(a) and (b) See explanation of adjustment (a) for the year ended June 30, 1960.

DISTRIBUTION OF INCOME

Name of Partner	Ordinary Income
Basye, James A.	$ 37,250.18
Lynn, Carol (Carol Cook)	19,155.84
Grant, Henry Donald	41,496.80
Fishler, Maurice C.	31,055.26
Hunter, Jessamine S.	25,537.51
Hunter, William S.	32,207.64
Other Partners	7,213,878.46
Total	$7,400,581.69

Form 2848
(Rev. June 1964)

U.S. Treasury Department—Internal Revenue Service

GENERAL POWER OF ATTORN.

IMPORTANT—Please read instructions on reverse before completing this form

Name and address of principal(s)

James A. and Evelyn E. Basye
6114 Oceanview Drive
Oakland, California

hereby appoint(s) (Please read address of appointee(s))

Leonard Marcusson, 1924 Broadway - 6th Floor, Oakland, California;
Franklin C. Stark, Stanley E. Sparrowe and John F. Wells of
Financial Center Building, Oakland, California

as attorney(s) in fact to represent the principal(s) before any office of the Internal Revenue Service with respect to liquidity Internal Revenue tax matter(s) and year(s) or period(s)

Income tax matter for years 1960 through 1965

Said attorney(s) in fact shall, subject to revocation, have full power to perform any and all acts that the principal(s) can perform, including the power to receive (but not to endorse and collect) checks in payment of any refund of Internal Revenue taxes, penalties, or interest, to delegate authority or to substitute another attorney or agent; to execute waivers of restrictions on assessment or collection of deficiencies in tax, to execute consents extending the statutory period for assessment or collection of taxes; to execute a closing agreement under section 7121 of the Internal Revenue Code; to request of a tax holiday or a specific matter; and to execute a protest to a determination of taxes by a district director.

Copies of correspondence addressed to the taxpayer in proceedings involving the above matter(s) should be sent to:

Leonard Marcusson, 1924 Broadway - 6th Floor, Oakland, California
Stark & Champlin, 1100 Financial Center Building, Oakland, California 94612

Any prior powers of attorney filed with this office by the principal(s) relating to the matter(s) and the year(s) or period(s) specified above are hereby revoked.

SIGNATURE IF PRINCIPAL IS INDIVIDUAL OR HUSBAND AND WIFE

Signature of Principal	Date	Signature of Principal	Date
James A. Basye	12-22-64	Evelyn E. Basye	12/22/64

SIGNATURE IF PRINCIPAL IS PARTNERSHIP, ESTATE, CORPORATION, ETC.

Under penalties of perjury, I declare that I have the authority to execute this power of attorney on behalf of the principal.

Signature for Principal	Date	CORPORATE SEAL (If applicable)
Signature for Principal	Title	Date

NOTARIZATION

The above-named principal signing or for the principal(s) personally this day before me and acknowledged this power of attorney to be his/her/their voluntary act and deed.

Signature of Notary	
Dorothy Mathes	
Notary Public, State of California - Principal Office, Alameda County	
My Commission Expires Nov. 13, 1967	
330 West MacArthur Blvd., Oakland, Calif.	

OR WITNESSING

This power of attorney was signed by or for the principal(s) by a person or persons known to, and in the presence of, the two disinterested witnesses whose signatures appear below:

Signature of Witness	Date
Signature of Witness	Date

CERTIFICATION BY DISBARRED ATTORNEY OR AGENT IN LIEU OF WITNESSING OR NOTARIZATION

I certify that I am in good standing and entitled to practice before the Internal Revenue Service (the following is applicable only if the principal is other than an individual or husband and wife) that to the best of my knowledge and belief, the person(s) signing above has/have the authority to execute this power of attorney on behalf of the principal.

Signature of Attorney-in-Fact	Enrollment Card Number	Signature Date or Card

Form 2848 (Rev.)

IN THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF CALIFORNIA SOUTHERN DIVISION

[*Caption Omitted*]

Civil No. 44352
Answer

Comes now the defendant, United States of America, and for answer to plaintiffs' complaint herein, admits, denies and alleges as follows:

ANSWER TO FIRST CAUSE OF ACTION

I

Admits the allegations contained in paragraph I, except denies that the Internal Revenue taxes therein referred to were overpaid.

II

Admits the allegations contained in paragraph II.

III

Denies the allegations contained in paragraph III; alleges that a deficiency in income tax in the sum of $1,424.02 together with interest in the sum of $356.70 was assessed on July 2, 1965.

IV

Denies the allegations contained in paragraph IV, except alleges that the amount of the deficiency in tax and interest assessed on July 2, 1965 was prepaid on June 18, 1965.

V

Admits the allegations contained in paragraph V, except denies that the taxes therein referred to were overpaid and further denies each and every substantive allegation contained in said claim for refund.

VI

Denies the allegations contained in paragraph VI.

VII

Denies the allegations contained in paragraph VII, except admits that no portion of said deficiency of tax and interest have been refunded to plaintiffs.

VIII

Denies the allegations contained in paragraph VIII.

ANSWER TO SECOND CAUSE OF ACTION

I

Reaffirms and incorporates by reference every admission, denial and allegation contained in paragraph I of the answer to the first cause of action.

II

Admits the allegations contained in paragraph II.

III

Denies the allegations contained in paragraph III; alleges that a deficiency in income tax in the sum of $1,586.93 together with interest in the sum of $302.30 was assessed on July 2, 1965.

IV

Denies the allegations contained in paragraph IV, except alleges that on June 18, 1965 the plaintiffs prepaid the taxes assessed on July 2, 1965.

V

Admits the allegations contained in paragraph V, except denies that the taxes therein referred to were overpaid and further denies each and every substantive allegation contained in said claim for refund.

VI

Denies the allegations contained in paragraph VI.

VII

Denies the allegations contained in paragraph VII, except

admits that no portion of said deficiency in tax and interest have been refunded to plaintiffs.

VIII

Denies the allegations contained in paragraph VIII.

WHEREFORE, having fully answered each and every allegation contained in plaintiffs' complaint herein, defendant prays judgment against the plaintiffs and in favor of the defendant dismissing plaintiffs' complaint herein with prejudice, and for its costs.

CECIL F. POOLE
United States Attorney

By: John M. Youngquist
JOHN M. YOUNGQUIST
Assistant United States Attorney

CERTIFICATE OF SERVICE BY MAIL

This certifies that a copy of the foregoing Answer was mailed on this 13th day of January, 1966, to Stark & Champlin, 1100 Financial Center Building, Oakland, California, 94612, attorneys for the plaintiffs in this action.

/s/ John M. Youngquist
JOHN M. YOUNGQUIST
Assistant United States Attorney

Notation re Complaints and Answers in Docket Nos. 44353, 44354, 44355, and 44356

The Complaints and Answers in Jack J. Cook and Carol L. Cook v. United States (Docket No. 44353), Maurice C. Fishler and Phyllis H. Fishler v. United States (Docket No. 44354), Henry Donald Grant and Jean M. Grant v. United States (Docket No. 44355), and William S. Hunter and Jessamine S. Hunter v. United States (Docket No. 44356) conform in all relevant respects to the Complaint and Answer in James A. Basye and Evelyn E. Basye v. United States (Docket No. 44352), as set forth above, and for that reason, by agreement of counsel, are not separately set forth in this Appendix.

IN THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF CALIFORNIA SOUTHERN DIVISION

Civil No. 44352

Civil No. 44353

Civil No. 44354

Civil No. 44355

Civil No. 44356

[*Caption Omitted*]

STIPULATION AND ORDER FOR CONSOLIDATION OF ACTIONS

IT IS HEREBY AGREED AND STIPULATED by and between the above-named parties to the above-entitled actions, by their respective undersigned attorneys, as follows:

1. That said actions are each civil actions for the refund of internal revenue taxes paid by the plaintiffs and that each action is related to each of the others in that each involves similar questions of fact and one common question of law—to wit: whether certain payments made by the Kaiser Foundation Health Plan, Inc., to a trust established pursuant to a certain trust agreement between said Health Plan and a limited partnership of physicians known as The Permanente Medical Group constituted income includible in the gross incomes of the plaintiffs under the Internal Revenue Code of 1954 for the taxable years at issue in said actions;

2. That consolidation of said actions for trial and for purposes of all proceedings heretofore or hereafter had in said actions will tend to avoid unnecessary costs and delay, will not prejudice any party and will substantially expedite justice in each and all of said actions; and

3. That said actions therefore be consolidated for all purposes by order of the Court.

Dated: March 11, 1966

STARK & CHAMPLIN
By: John F. Banker
JOHN F. BANKER
Attorneys for all Plaintiffs

CECIL F. POOLE
United States Attorney
By: John M. Youngquist
JOHN M. YOUNGQUIST
Assistant United States Attorney
Attorneys for Defendant

ORDER

The Court having duly considered the foregoing stipulation of the parties to the above-entitled actions and approving said stipulation, it is hereby

ORDERED that said actions be and the same hereby are consolidated for all purposes, including discovery heretofore or hereafter undertaken in said actions, pre-trial, trial, and all other proceedings.

Dated: 3/16/66

/s/ Albert C. Wollenberg
ALBERT C. WOLLENBERG
United States District Judge

UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF CALIFORNIA SOUTHERN DIVISION

GEORGE W. SOROKOWSKI AND NADIA SOROKOWSKI, PLAINTIFFS, VS. UNITED STATES OF AMERICA, DEFENDANT.	Civil No. 45575 Complaint for Refund of Internal Revenue Taxes

Plaintiffs allege:

I.

Plaintiffs are citizens of the United States and reside in the County of San Francisco, in the Southern Division of the Northern District of California. This Court has jurisdiction and venue of this action for refund of Internal Revenue Taxes overpaid under Title 26, U.S.C. § 7422, Title 28, U.S.C. §§ 1346(a)(1), 1402(a)(1), and the Internal Revenue Laws of the United States of America.

II.

On or about April 15, 1961, plaintiffs filed with defendant their federal income tax return for the year 1960 showing tax due thereon in the amount of $8,215.23. Plaintiffs paid the tax as shown on said income tax return on or before April 15, 1961.

III.

On or about May 4, 1966, defendant illegally and erroneously assessed against plaintiffs as an alleged deficiency of income tax the sum of $692.86, plus interest.

IV.

On or about April 25, 1966, defendant illegally and erroneously collected the aforesaid deficiency in tax from plaintiffs, and on or about May 25, 1966 collected the interest thereon.

V.

On or about June 15, 1966, plaintiffs filed a claim for refund of tax overpaid, in the amount hereinabove set forth, plus interest thereon. A copy of said refund claim is attached hereto as Exhibit A and is by this reference incorporated herein. On or about August 9, 1966, notice of disallowance of said claim for refund was issued by defendant.

VI.

Plaintiffs have overpaid their income tax for the year 1960 in the amount of $692.86, plus interest.

VII.

No portion of said overpayment of tax and interest has been refunded by defendant to plaintiffs, and no legal offsets or credits exist with respect thereto.

VIII.

Defendant is indebted to plaintiffs in the sum set forth in paragraph VI above, together with interest on said sum from the date of overpayment, on or about April 25, 1966, according to law.

WHEREFORE, plaintiffs demand judgment against defendant for the sum of $692.86, together with interest provided by law, and costs.

SECOND CAUSE OF ACTION

I.

Plaintiffs incorporate herein by reference paragraph I of their First Cause of Action.

II.

On or about April 15, 1962, plaintiffs filed with defendant their federal income tax return for the year 1961 showing tax due thereon in the amount of $8,601.63. Plaintiffs paid the tax as shown on said income tax return on or before April 15, 1961.

III.

On or about May 4, 1966, defendant illegally and erroneously assessed against plaintiffs as an alleged deficiency of income tax the sum of $792.70, plus interest.

IV.

On or about April 25, 1966, defendant illegally and erroneously collected the aforesaid deficiency in tax from plaintiffs, and on or about May 25, 1966 collected the interest thereon.

V.

On or about June 15, 1966, plaintiffs filed a claim for refund of tax overpaid, in the amount hereinabove set forth, plus interest thereon. A copy of said refund claim is attached hereto as Exhibit B and is by this reference incorporated herein. On or about August 9, 1966, notice of disallowance of said claim for refund was issued by defendant.

VI.

Plaintiffs have overpaid their income tax for the year 1961 in the amount of $792.70, plus interest.

VII.

No portion of said overpayment of tax and interest has been refunded by defendant to plaintiffs, and no legal offsets or credits exist with respect thereto.

VIII.

Defendant is indebted to plaintiffs in the sum set forth in paragraph VI above, together with interest on said sum from the date of overpayment, on or about April 25, 1966, according to law.

WHEREFORE, plaintiffs demand judgment against defendant for the sum of $792.70, together with interest provided by law, and costs.

THIRD CAUSE OF ACTION

I.

Plaintiffs incorporate herein by reference paragraph I of their First Cause of Action.

II.

On or about April 15, 1963, plaintiffs filed with defendant their federal income tax return for the year 1962 showing tax due thereon in the amount of $12,281.35. Plaintiffs paid the tax as shown on said income tax return on or before April 15, 1963.

III.

On or about May 4, 1966, defendant illegally and erroneously assessed against plaintiffs as an alleged deficiency of income tax the sum of $873.42, plus interest.

IV.

On or about April 25, 1966, defendant illegally and erroneously collected the aforesaid deficiency in tax from plaintiffs, and on or about May 25, 1966 collected the interest thereon.

V.

On or about June 15, 1966, plaintiffs filed a claim for refund of tax overpaid, in the amount hereinabove set forth, plus interest thereon. A copy of said refund claim is attached hereto as Exhibit C and is by this reference incorporated herein. On or about August 9, 1966, notice of disallowance of said claim for refund was issued by defendant.

VI.

Plaintiffs have overpaid their income tax for the year 1962 in the amount of $873.42, plus interest.

VII.

No portion of said overpayment of tax and interest has been refunded by defendant to plaintiffs, and no legal offsets or credits exist with respect thereto.

VIII.

Defendant is indebted to plaintiffs in the sum set forth in paragraph VI above, together with interest on said sum from the date of overpayment, on or about April 25, 1966, according to law.

WHEREFORE, plaintiffs demand judgment against defendant for the sum of $873.42, together with interest provided by law, and costs.

FOURTH CAUSE OF ACTION

I.

Plaintiffs incorporate herein by reference paragraph I of their First Cause of Action.

II.

On or about April 15, 1964, plaintiffs filed with defendant their federal income tax return for the year 1963 showing tax due thereon in the amount of $11,179.73. Plaintiffs paid the tax as shown on said income tax return on or before April 15, 1964.

III.

On or about May 4, 1966, defendant illegally and erroneously assessed against plaintiffs as an alleged deficiency of income tax the sum of $902.69, plus interest.

IV.

On or about April 25, 1966, defendant illegally and erroneously collected the aforesaid deficiency in tax from plaintiffs, and on or about May 25, 1966 collected the interest thereon.

V.

On or about June 15, 1966, plaintiffs filed a claim for refund of tax overpaid, in the amount hereinabove set forth, plus interest thereon. A copy of said refund claim is attached hereto as Exhibit D and is by this reference incorporated herein. On or about August 9, 1966, notice of disallowance of said claim for refund was issued by defendant.

VI.

Plaintiffs have overpaid their income tax for the year 1963 in the amount of $902.69, plus interest.

VII.

No portion of said overpayment of tax and interest has been refunded by defendant to plaintiffs, and no legal offsets or credits exist with respect thereto.

VIII.

Defendant is indebted to plaintiffs in the sum set forth in paragraph VI above, together with interest on said sum from the date of overpayment, on or about April 25, 1966, according to law.

WHEREFORE, plaintiffs demand judgment against defendant for the sum of $902.69, together with interest provided by law, and costs.

Dated: August 25, 1966.

STARK & CHAMPLIN
By John F. Banker
JOHN F. BANKER
Attorneys for Plaintiffs

U.S. TREASURY DEPARTMENT—INTERNAL REVENUE SERVICE

CLAIM

TO BE FILED WITH THE DISTRICT DIRECTOR WHERE ASSESSMENT WAS MADE OR TAX PAID

Form 843
(Rev. July 1965)

District Director's Stamp
(Date Received)

The District Director will indicate in the block below the kind of claim filed, and fill in, where required.

- ☐ Refund of Taxes Illegally, Erroneously, or Excessively Collected.
- ☐ Refund of Amount Paid for Stamps Unused, or Used in Error or Excess.
- ☐ Abatement of Tax Assessed (not applicable to estate, gift, or income taxes).

PLEASE TYPE OR PRINT PLAINLY

Name of taxpayer or purchaser of stamps
George W. and Nadia Sorokowski

Number and street
3267 Jackson Street

City, town, State, Postal ZIP Code
San Francisco, California 94118

Fill in applicable items—Attach letter size sheets if space is not sufficient

a. Your social security number
547 | 52 | 1067

Wife's number, if joint return
553 | 48 | 8974

b. If an employer, enter employer identification number

c. District in which return (if any) was filed
San Francisco

d. Name and address shown on return, if different from above
George W. & Nadia Sorokowski
2690 Jackson, San Francisco 15, Calif.

e. Period—if for tax reported on annual basis, prepare separate form for each taxable year
From January 1, 1960, to December 31, 1960

f. Kind of tax
Income

g. Amount of assessment
$692.86 (plus interest pd)

Dates of payment
April 25, 1966

h. Date stamps were purchased from Government

i. Amount to be refunded (If income tax, complete computation below)

j. Amount to be abated (not applicable to income, estate, or gift taxes)

k. The claimant believes that this claim should be allowed for the following reasons:

See Attached paragraph K, by this reference incorporated herein

COMPUTATION OF INCOME TAX REFUND	Income Tax
1. Tax withheld	599.14
2. Estimated tax paid	6,500.00
3. Tax paid with original return	1,116.09
4. Any additional income tax paid	692.86
5. Total tax paid (Add lines 1-4)	8,908.09
6. Less: Your computation of correct tax	8,215.23
7. Amount of overpayment	692.86

8. Amount previously refunded	.....
9. Net overpayment (Enter in item 1 above) (not including interest paid)	692.56

Under penalties of perjury, I declare that this claim, including any accompanying schedules and statements, has been examined by me and to the best of my knowledge and belief it is true and correct. George W. and Nadia Borokowski

Signed by John F. Banker, Attorney in Fact
(Power of Attorney attached)

Dated, June 15, 1966

SEE INSTRUCTIONS ON REVERSE

EXHIBIT A

k. The Commissioner of Internal Revenue assessed an income tax deficiency of $692.86 for the year 1960, an income tax deficiency of $792.70 for the year 1961, an income tax deficiency of $873.42 for the year 1962, and an income tax deficiency of $902.69 for the year 1963 against taxpayers Drs. George W. and Nadia Sorokowski. The basis of the deficiency assessments was set forth in the "Preliminary Statement" Form 1907 (Schedules 1-8 attached), dated April 18, 1966. A copy of that statement is attached hereto as Exhibit "A". Taxpayers paid these assessments on April 25, 1966. Interest thereon in the amount of $668.99 was paid by taxpayers on May 25, 1966.

A summary of the facts upon which this claim is based is as follows:

Taxpayer Nadia Sorokowski was a participant in the Retirement Plan for the Permanente Medical Group. Said Retirement Plan was established July 1, 1959, as the result of negotiations between two independent organizations, Kaiser Foundation Health Plan, Inc., a California nonprofit corporation (hereinafter called "Health Plan"), on the one hand, and The Permanente Medical Group, a partnership of physicians (hereinafter called "Medical Group"), on the other hand. Said Retirement Plan was not established by Medical Group alone, nor for its benefit alone, but was established in good faith to serve the independent, and in some respects conflicting interests of Health Plan, Medical Group and the participating physicians.

Pursuant to said Retirement Plan, a trust was established to which Health Plan made certain contributions. No contributions were made to the trust by Medical Group. Individual participating physicians may become entitled to retirement benefits from said trust upon fulfilling certain conditions. Such individual physicians are the only beneficiaries of said trust, and Medical Group has no right, either present or prospective, in the funds contributed by Health Plan to the trust. No income in cash or its equivalent was actually or constructively received by Medical Group, nor was any sum properly accruable to Medical Group, nor did Medical Group receive or realize income in any manner or form, as the result of contributions by Health Plan to the trust.

Taxpayers' returns for 1960, 1961, 1962 and 1963 reported income on the cash receipts and disbursements basis.

Taxpayer Nadia Sorokowski had no right to receive any money or other benefits from the trust during the years 1960, 1961, 1962 and 1963; her expectancy of future benefits under said Retirement Plan was dependent upon fulfilling certain conditions precedent, and was subject to forfeiture upon the happening of various contingencies. No income in cash or its equivalent was actually or constructively received by taxpayers from the trust, or otherwise, nor did taxpayers receive or realize income in any manner or form as a result of Dr. Sorokowski's participation in the Retirement Plan. Subsequent to the years involved, Dr. Sorokowski terminated her association with Medical Group and her expectancy of future benefits under the trust was thereupon forfeited. Dr. Sorokowski has not and never will receive any benefit of any kind whatsoever by virtue of the 1960, 1961, 1962 and 1963 payments by Health Plan into the Trust.

Copies of the documents supporting the foregoing factual summary have been furnished to the Internal Revenue Service. Additional copies will be furnished on request.

Taxpayers claim this refund on the grounds that the partnership of which Dr. Sorokowski was a member did not receive nor realize income in any manner or form as a result of the establishment of said Retirement Plan nor as a result of any payments to the trust; that no part of the payments to said trust were accruable to the partnership; that the gross income as reported on taxpayers' return is correct and that the Commissioner's adjustments to their returns as set forth in Exhibit "A" is erroneous.

Taxpayers claim this refund on the further ground that Dr. Sorokowski did not during 1960, 1961, 1962 or 1963, nor can she at any time in the future, realize any income as an individual participant in said Retirement Plan, because neither cash nor its equivalent was or can be hereafter actually or constructively received by her nor did she or can she hereafter receive or realize income in any manner or form as a result of her participation in the Retirement Plan.

U.S. TREASURY DEPARTMENT—INTERNAL REVENUE SERVICE

CLAIM

TO BE FILED WITH THE DISTRICT DIRECTOR WHERE ASSESSMENT WAS MADE OR TAX PAID

Form 843
(Rev. July 1965)

District Director's Stamp
(Date Received)

The District Director will indicate in the block below the kind of claim filed, and fill in, where required.

- ☐ Refund of Taxes Illegally, Erroneously, or Excessively Collected.
- ☐ Refund of Amount Paid for Stamps Unused, or Used in Error or Excess.
- ☐ Abatement of Tax Assessed (not applicable to estate, gift, or income taxes).

PLEASE TYPE OR PRINT PLAINLY

Name of taxpayer or purchaser of stamps
George W. and Nadia Sorokowski

Number and street
3267 Jackson Street

City, town, State, Postal ZIP Code
San Francisco, California 94118

Fill in applicable items—Attach letter size sheets if space is not sufficient

a. Your social security number
547 | 52 | 1067

Wife's number, if joint return
553 | 48 | 8974

b. If an employer, enter employer identification number

c. District in which return (if any) was filed
San Francisco

d. Name and address shown on return, if different from above
2795 Vallejo Street, S.F. 23

e. Period—if for tax reported on annual basis, prepare separate form for each taxable year
From January 1, 1961 to December 31, 1961

f. Kind of tax
Income

g. Amount of assessment
$792.70 (Plus Interest Paid)

Dates of payment
April 25, 1966

h. Date stamps were purchased from Government

i. Amount to be refunded (If income tax, complete computation below)
$792.70 (Plus Interest Paid)

j. Amount to be abated (not applicable to income, estate, or gift taxes)
$

k. The claimant believes that this claim should be allowed for the following reasons:

See Attached paragraph K, by this reference incorporated herein

COMPUTATION OF INCOME TAX REFUND	Income Tax
1. Tax withheld	
2. Estimated tax paid	7,000.00
3. Tax paid with original return	1,601.63
4. Any additional income tax paid	792.70
5. Total tax paid (Add lines 1-4)	9,394.33
6. Less: Your computation of correct tax	8,601.63
7. Amount of overpayment	792.70

8. Amount previously refunded	.....
9. Net overpayment (Enter in item 1 above) (not including interest paid)	792.70

Under penalties of perjury, I declare that this claim, including any accompanying schedules and statements, has been examined by me and to the best of my knowledge and belief it is true and correct. George W. and Nadia Sorokowski

Signed by John F. Banker, Attorney in Fact
(Power of Attorney attached)

Dated, June 15, 1966

SEE INSTRUCTIONS ON REVERSE

EXHIBIT B

k. The Commissioner of Internal Revenue assessed an income tax deficiency of $692.86 for the year 1960, an income tax deficiency of $792.70 for the year 1961, an income tax deficiency of $873.42 for the year 1962, and an income tax deficiency of $902.69 for the year 1963 against taxpayers Drs. George W. and Nadia Sorokowski. The basis of the deficiency assessments was set forth in the "Preliminary Statement" Form 1907 (Schedules 1-8 attached), dated April 18, 1966. A copy of that statement is attached hereto as Exhibit "A". Taxpayers paid these assessments on April 25, 1966. Interest thereon in the amount of $668.99 was paid by taxpayers on May 25, 1966.

A summary of the facts upon which this claim is based is as follows:

Taxpayer Nadia Sorokowski was a participant in the Retirement Plan for the Permanente Medical Group. Said Retirement Plan was established July 1, 1959, as the result of negotiations between two independent organizations, Kaiser Foundation Health Plan, Inc., a California non-profit corporation (hereinafter called "Health Plan"), on the one hand, and The Permanente Medical Group, a partnership of physicians (hereinafter called "Medical Group"), on the other hand. Said Retirement Plan was not established by Medical Group alone, nor for its benefit alone, but was established in good faith to serve the independent, and in some respects conflicting interests of Health Plan, Medical Group and the participating physicians.

Pursuant to said Retirement Plan, a trust was established to which Health Plan made certain contributions. No contributions were made to the trust by Medical Group. Individual participating physicians may become entitled to retirement benefits from said trust upon fulfilling certain conditions. Such individual physicians are the only beneficiaries of said trust, and Medical Group has no right, either present or prospective, in the funds contributed by Health Plan to the trust. No income in cash or its equivalent was actually or constructively received by Medical Group, nor was any sum properly accruable to Medical Group, nor did Medical Group receive or realize income in any manner or form, as the result of contributions by Health Plan to the trust.

Taxpayers' returns for 1960, 1961, 1962 and 1963 reported income on the cash receipts and disbursements

basis. Taxpayer Nadia Sorokowski had no right to receive any money or other benefits from the trust during the years 1960, 1961, 1962 and 1963; her expectancy of future benefits under said Retirement Plan was dependent upon fulfilling certain conditions precedent, and was subject to forfeiture upon the happening of various contingencies. No income in cash or its equivalent was actually or constructively received by taxpayers from the trust, or otherwise, nor did taxpayers receive or realize income in any manner or form as a result of Dr. Sorokowski's participation in the Retirement Plan. Subsequent to the years involved, Dr. Sorokowski terminated her association with Medical Group and her expectancy of future benefits under the trust was thereupon forfeited. Dr. Sorokowski has not and never will receive any benefit of any kind whatsoever by virtue of the 1960, 1961, 1962 and 1963 payments by Health Plan into the Trust.

Copies of the documents supporting the foregoing factual summary have been furnished to the Internal Revenue Service. Additional copies will be furnished on request.

Taxpayers claim this refund on the grounds that the partnership of which Dr. Sorokowski was a member did not receive nor realize income in any manner or form as a result of the establishment of said Retirement Plan nor as a result of any payments to the trust; that no part of the payments to said trust were accruable to the partnership; that the gross income as reported on taxpayers' return is correct and that the Commissioner's adjustments to their returns as set forth in Exhibit "A" is erroneous.

Taxpayers claim this refund on the further ground that Dr. Sorokowski did not during 1960, 1961, 1962 or 1963, nor can she at any time in the future, realize any income as an individual participant in said Retirement Plan, because neither cash nor its equivalent was or can be hereafter actually or constructively received by her nor did she or can she hereafter receive or realize income in any manner or form as a result of her participation in the Retirement Plan.

U.S. TREASURY DEPARTMENT—INTERNAL REVENUE SERVICE

CLAIM

TO BE FILED WITH THE DISTRICT DIRECTOR WHERE ASSESSMENT WAS MADE OR TAX PAID

Form 843
(Rev. July 1965)

District Director's Stamp
(Date Received)

The District Director will indicate in the block below the kind of claim filed, and fill in, where required.

☐ Refund of Taxes Illegally, Erroneously, or Excessively Collected.
☐ Refund of Amount Paid for Stamps Unused, or Used in Error or Excess.
☐ Abatement of Tax Assessed (not applicable to estate, gift, or income taxes).

PLEASE TYPE OR PRINT PLAINLY

Name of taxpayer or purchaser of stamps
George W. and Nadia Sorokowski

Number and street
3267 Jackson Street

City, town, State, Postal ZIP Code
San Francisco, California 94118

Fill in applicable items—Attach letter size sheets if space is not sufficient

a. Your social security number
547 | 52 | 1067

Wife's number, if joint return
553 | 48 | 8974

b. If an employer, enter employer identification number

c. District in which return (if any) was filed
San Francisco

d. Name and address shown on return, if different from above
2795 Vallejo Street
San Francisco 23, California

e. Period—if for tax reported on annual basis, prepare separate form for each taxable year
From January 1, 1962, to December 31, 1962

f. Kind of tax
Income

g. Amount of assessment
$873.42 (Plus interest paid)

Dates of payment
April 25, 1966

h. Date stamps were purchased from Government

i. Amount to be refunded (If income tax, complete computation below)
$873.42 (Plus interest paid)

j. Amount to be abated (not applicable to income, estate, or gift taxes)
$

k. The claimant believes that this claim should be allowed for the following reasons:

See Attached paragraph K, by this reference incorporated herein

COMPUTATION OF INCOME TAX REFUND	Income Tax
1. Tax withheld	.....
2. Estimated tax paid	8,000.00
3. Tax paid with original return	4,281.35
4. Any additional income tax paid	873.42
5. Total tax paid (Add lines 1-4)	13,154.77
6. Less: Your computation of correct tax	12,281.35
7. Amount of overpayment	873.42

8. Amount previously refunded	.....
9. Net overpayment (Enter in item 1 above) (not including interest paid)	873.42

Under penalties of perjury, I declare that this claim, including any accompanying schedules and statements, has been examined by me and to the best of my knowledge and belief it is true and correct. George W. and Nadia Sorokowski

Signed by John F. Banker, Attorney in Fact
(Power of Attorney attached)

Dated, June 15, 1946

SEE INSTRUCTIONS ON REVERSE

EXHIBIT C

k. The Commissioner of Internal Revenue assessed an income tax deficiency of $692.86 for the year 1960, an income tax deficiency of $792.70 for the year 1961, an income tax deficiency of $873.42 for the year 1962, and an income tax deficiency of $902.69 for the year 1963 against taxpayers Drs. George W. and Nadia Sorokowski. The basis of the deficiency assessments was set forth in the "Preliminary Statement" Form 1907 (Schedules 1-8 attached), dated April 18, 1966. A copy of that statement is attached hereto as Exhibit "A". Taxpayers paid these assessments on April 25, 1966. Interest thereon in the amount of $668.99 was paid by taxpayers on May 25, 1966.

A summary of the facts upon which this claim is based is as follows:

Taxpayer Nadia Sorokowski was a participant in the Retirement Plan for the Permanente Medical Group. Said Retirement Plan was established July 1, 1959, as the result of negotiations between two independent organizations, Kaiser Foundation Health Plan, Inc., a California nonprofit corporation (hereinafter called "Health Plan"), on the one hand, and The Permanente Medical Group, a partnership of physicians (hereinafter called "Medical Group"), on the other hand. Said Retirement Plan was not established by Medical Group alone, nor for its benefit alone, but was established in good faith to serve the independent, and in some respects conflicting interests of Health Plan, Medical Group and the participating physicians.

Pursuant to said Retirement Plan, a trust was established to which Health Plan made certain contributions. No contributions were made to the trust by Medical Group. Individual participating physicians may become entitled to retirement benefits from said trust upon fulfilling certain conditions. Such individual physicians are the only beneficiaries of said trust, and Medical Group has no right, either present or prospective, in the funds contributed by Health Plan to the trust. No income in cash or its equivalent was actually or constructively received by Medical Group, nor was any sum properly accruable to Medical Group, nor did Medical Group receive or realize income in any manner or form, as the result of contributions by Health Plan to the trust.

Taxpayers' returns for 1960, 1961, 1962 and 1963 reported income on the cash receipts and disbursements basis. Taxpayer Nadia Sorokowski had no right to receive any money

or other benefits from the trust during the years 1960, 1961, 1962 and 1963; her expectancy of future benefits under said Retirement Plan was dependent upon fulfilling certain conditions precedent, and was subject to forfeiture upon the happening of various contingencies. No income in cash or its equivalent was actually or constructively received by taxpayers from the trust, or otherwise, nor did taxpayers receive or realize income in any manner or form as a result of Dr. Sorokowski's participation in the Retirement Plan. Subsequent to the years involved, Dr. Sorokowski terminated her association with Medical Group and her expectancy of future benefits under the trust was thereupon forfeited. Dr. Sorokowski has not and never will receive any benefit of any kind whatsoever by virtue of the 1960, 1961, 1962 and 1963 payments by Health Plan into the Trust.

Copies of the documents supporting the foregoing factual summary have been furnished to the Internal Revenue Service. Additional copies will be furnished on request.

Taxpayers claim this refund on the grounds that the partnership of which Dr. Sorokowski was a member did not receive nor realize income in any manner or form as a result of the establishment of said Retirement Plan nor as a result of any payments to the trust; that no part of the payments to said trust were accruable to the partnership; that the gross income as reported on taxpayers' return is correct and that the Commissioner's adjustments to their returns as set forth in Exhibit "A" is erroneous.

Taxpayers claim this refund on the further ground that Dr. Sorokowski did not during 1960, 1961, 1962 or 1963, nor can she at any time in the future, realize any income as an individual participant in said Retirement Plan, because neither cash nor its equivalent was or can be hereafter actually or constructively received by her nor did she or can she hereafter receive or realize income in any manner or form as a result of her participation in the Retirement Plan.

U.S. TREASURY DEPARTMENT—INTERNAL REVENUE SERVICE

CLAIM

TO BE FILED WITH THE DISTRICT DIRECTOR WHERE ASSESSMENT WAS MADE OR TAX PAID

Form 843
(Rev. July 1965)

District Director's Stamp
(Date Received)

The District Director will indicate in the block below the kind of claim filed, and fill in, where required.

- ☒ Refund of Taxes Illegally, Erroneously, or Excessively Collected.
- ☐ Refund of Amount Paid for Stamps Unused, or Used in Error or Excess.
- ☐ Abatement of Tax Assessed (not applicable to estate, gift, or income taxes).

PLEASE TYPE OR PRINT PLAINLY

Name of taxpayer or purchaser of stamps
George W. and Nadia Sorokowski

Number and street
1267 Jackson Street

City, town, State, Postal ZIP Code
San Francisco, California 94118

Fill in applicable items—Attach letter size sheets if space is not sufficient

a. Your social security number
547 | 52 | 1067

Wife's number, if joint return
553 | 48 | 8974

b. If an employer, enter employer identification number

c. District in which return (if any) was filed
San Francisco

d. Name and address shown on return, if different from above
George W. and Nadia Sorokowski
726 # 1 Camino Del Mar, San Francisco, Calif. 94121

e. Period—if for tax reported on annual basis, prepare separate form for each taxable year
From January 1, 1963, to December 31, 1963

f. Kind of tax
Income

g. Amount of assessment
$902.69 (Plus Interest Paid)

Dates of payment
April 25, 1966

h. Date stamps were purchased from Government

i. Amount to be refunded (If income tax, complete computation below)
$902.69 (Plus interest paid)

j. Amount to be abated (not applicable to income, estate, or gift taxes)
$

k. The claimant believes that this claim should be allowed for the following reasons:

See Attached paragraph K, by this reference incorporated herein

COMPUTATION OF INCOME TAX REFUND	Income Tax
1. Tax withheld	.....
2. Estimated tax paid	6,039.90
3. Tax paid with original return	5,139.83
4. Any additional income tax paid	902.69
5. Total tax paid (Add lines 1-4)	12,082.42
6. Less: Your computation of correct tax	11,179.73
7. Amount of overpayment	902.69

8. Amount previously refunded.....
9. Net overpayment (Enter in item 1 above) (not including interest paid) 902.89

Under penalties of perjury, I declare that this claim, including any accompanying schedules and statements, has been examined by me and to the best of my knowledge and belief it is true and correct. George W. and Nadia Sorokowski

Signed by John F. Banker, Attorney in Fact
(Power of Attorney attached)

Dated, June 15, 1966

SEE INSTRUCTIONS ON REVERSE

EXHIBIT D

k. The Commissioner of Internal Revenue assessed an income tax deficiency of $692.86 for the year 1960, an income tax deficiency of $792.70 for the year 1961, an income tax deficiency of $873.42 for the year 1962, and an income tax deficiency of $902.69 for the year 1963 against taxpayers Dra. George W. and Nadia Sorokowski. The basis of the deficiency assessments was set forth in the "Preliminary Statement" Form 1907 (Schedules 1-8 attached), dated April 18, 1966. A copy of that statement is attached hereto as Exhibit "A". Taxpayers paid these assessments on April 25, 1966. Interest thereon in the amount of $668.99 was paid by taxpayers on May 25, 1966.

A summary of the facts upon which this claim is based is as follows:

Taxpayer Nadia Sorokowski was a participant in the Retirement Plan for the Permanente Medical Group. Said Retirement Plan was established July 1, 1959, as the result of negotiations between two independent organizations, Kaiser Foundation Health Plan, Inc., a California nonprofit corporation (hereinafter called "Health Plan"), on the one hand, and The Permanente Medical Group, a partnership of physicians (hereinafter called "Medical Group"), on the other hand. Said Retirement Plan was not established by Medical Group alone, nor for its benefit alone, but was established in good faith to serve the independent, and in some respects conflicting interests of Health Plan, Medical Group and the participating physicians.

Pursuant to said Retirement Plan, a trust was established to which Health Plan made certain contributions. No contributions were made to the trust by Medical Group. Individual participating physicians may become entitled to retirement benefits from said trust upon fulfilling certain conditions. Such individual physicians are the only beneficiaries of said trust, and Medical Group has no right, either present or prospective, in the funds contributed by Health Plan to the trust. No income in cash or its equivalent was actually or constructively received by Medical Group, nor was any sum properly accruable to Medical Group, nor did Medical Group receive or realize income in any manner or form, as the result of contributions by Health Plan to the trust.

Taxpayers' returns for 1960, 1961, 1962 and 1963 reported income on the cash receipts and disbursements basis. Taxpayer Nadia Sorokowski had no right to receive

any money or other benefits from the trust during the years 1960, 1961, 1962 and 1963; her expectancy of future benefits under said Retirement Plan was dependent upon fulfilling certain conditions precedent, and was subject to forfeiture upon the happening of various contingencies. No income in cash or its equivalent was actually or constructively received by taxpayers from the trust, or otherwise, nor did taxpayers receive or realize income in any manner or form as a result of Dr. Sorokowski's participation in the Retirement Plan. Subsequent to the years involved, Dr. Sorokowski terminated her association with Medical Group and her expectancy of future benefits under the trust was thereupon forfeited. Dr. Sorokowski has not and never will receive any benefit of any kind whatsoever by virtue of the 1960, 1961, 1962 and 1963 payments by Health Plan into the Trust.

Copies of the documents supporting the foregoing factual summary have been furnished to the Internal Revenue Service. Additional copies will be furnished on request.

Taxpayers claim this refund on the grounds that the partnership of which Dr. Sorokowski was a member did not receive nor realize income in any manner or form as a result of the establishment of said Retirement Plan nor as a result of any payments to the trust; that no part of the payments to said trust were accruable to the partnership; that the gross income as reported on taxpayers' return is correct and that the Commissioner's adjustments to their returns as set forth in Exhibit "A" is erroneous.

Taxpayers claim this refund on the further ground that Dr. Sorokowski did not during 1960, 1961, 1962 or 1963, nor can she at any time in the future, realize any income as an individual participant in said Retirement Plan, because neither cash nor its equivalent was or can be hereafter actually or constructively received by her nor did she or can she hereafter receive or realize income in any manner or form as a result of her participation in the Retirement Plan.

IN THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF CALIFORNIA

[Caption Omitted]

Civil No. 45575
Answer

Comes now the defendant, United States of America, and for answer to plaintiffs' complaint herein, states to the Court that:

ANSWER TO FIRST CAUSE OF ACTION

I

Admits the allegations contained in paragraph I, except denies the taxes therein referred to were overpaid.

II

Admits the allegations contained in the first sentence of paragraph II (beginning on line 26 and ending with the figures $8,215.23 on line 28, page 1). It is without knowledge or information sufficient to form a belief as to the truth of the allegations contained in the second sentence (beginning with the word "plaintiffs" on line 28 and ending on line 29, page 1).

III

Admits the allegations contained in paragraph III, except denies that the assessment therein referred to was illegally and erroneously made against plaintiffs.

IV

Admits the allegations contained in paragraph IV, except denies that the deficiency therein referred to was illegally and erroneously collected.

V

Admits the allegations contained in paragraph V, except denies that the taxes therein referred to were overpaid and further denies each and every substantive allegation contained in said claim for refund.

VI

Denies the allegations contained in paragraph VI.

VII

Denies the allegations contained in paragraph VII, except admits that no portion of the tax and interest therein referred to has been refunded to the plaintiffs.

VIII

Denies the allegations contained in paragraph VIII.

ANSWER TO SECOND CAUSE OF ACTION

I

It reaffirms and incorporates herein by reference every admission, denial and allegation contained in paragraph I of its answer to first cause of action.

II

It admits the allegations contained in the first sentence of paragraph II (beginning on line 31, page 2 and ending with the figures $8,601.63 on line 1, page 3). It is without knowledge or information sufficient to form a belief as to the truth of the allegations contained in the second sentence (beginning with the word "Plaintiffs" on line 1 and ending on line 2, page 3).

III

Admits the allegations contained in paragraph III, except denies that the assessment therein referred to was illegally and erroneously made against plaintiffs.

IV

Admits the allegations contained in paragraph IV, except denies that the deficiency therein referred to was illegally and erroneously collected.

V

Admits the allegations contained in paragraph V, except denies that the taxes therein referred to were overpaid and

further denies each and every substantive allegation contained in said claim for refund.

VI

Denies the allegations contained in paragraph VI.

VII

Denies the allegations contained in paragraph VII, except admits that no portion of the tax and interest therein referred to has been refunded to the plaintiffs.

VIII

Denies the allegations contained in paragraph VIII.

ANSWER TO THIRD CAUSE OF ACTION

I

It reaffirms and incorporates herein by reference every admission, denial and allegation contained in paragraph I of its answer to first cause of action.

II

It admits the allegations contained in the first sentence of paragraph II (beginning on line 6 and ending with the figures $12,281.35 on line 8, page 4). It is without knowledge or information sufficient to form a belief as to the truth of the allegations contained in the second sentence (beginning with the word "Plaintiffs" on line 8 and ending on line 9, page 4).

III

Admits the allegations contained in paragraph III, except denies that the assessment therein referred to was illegally and erroneously made against plaintiffs.

IV

Admits the allegations contained in paragraph IV, except denies that the deficiency therein referred to was illegally and erroneously collected.

V

Admits the allegations contained in paragraph V, except denies that the taxes therein referred to were overpaid and further denies each and every substantive allegation contained in said claim for refund.

VI

Denies the allegations contained in paragraph VI.

VII

Denies the allegations contained in paragraph VII, except admits that no portion of the tax and interest therein referred to has been refunded to the plaintiffs.

VIII

Denies the allegations contained in paragraph VIII.

ANSWER TO FOURTH CAUSE OF ACTION

I

It reaffirms and incorporates herein by reference every admission, denial and allegation contained in paragraph I of its answer to first cause of action.

II

It admits the allegations contained in the first sentence of paragraph II (beginning on line 11 and ending with the figures $11,179.73 on line 13, page 5). It is without knowledge or information sufficient to form a belief as to the truth of the allegations contained in the second sentence (beginning with the word "Plaintiffs" on line 13 and ending on line 14, page 5).

III

Admits the allegations contained in paragraph III, except denies that the assessment therein referred to was illegally and erroneously made against plaintiffs.

IV

Admits the allegations contained in paragraph IV, ex-

cept denies that the deficiency therein referred to was illegally and erroneously collected.

V

Admits the allegations contained in paragraph V, except denies that the taxes therein referred to were overpaid and further denies each and every substantive allegation contained in said claim for refund.

VI

Denies the allegations contained in paragraph VI.

VII

Denies the allegations contained in paragraph VII, except admits that no portion of the tax and interest therein referred to has been refunded to the plaintiffs.

VIII

Denies the allegations contained in paragraph VIII.

WHEREFORE, having fully answered each and every allegation contained in plaintiffs' complaint herein, defendant prays judgment against the plaintiffs and in favor of the defendant dismissing plaintiffs' complaint herein, with prejudice and for its costs.

CECIL F. POOLE
United States Attorney
By: Richard L. Carico
RICHARD L. CARICO
Assistant United States Attorney

CERTIFICATE OF SERVICE BY MAIL

A copy of the foregoing Answer was mailed this 24th day of October, 1966, to John F. Banker, Esq., Stark & Champlin, 1100 Financial Center Building, Oakland, California 94612.

/s/ John M. Youngquist
JOHN M. YOUNGQUIST
Assistant United States Attorney

IN THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF CALIFORNIA

[*Caption Omitted*]

Civil No. 45575
Stipulation for and Order Granting Leave for Defendant to File Counter-Claim by Supplemental Pleading

IT IS HEREBY AGREED, STIPULATED AND REQUESTED by and between the parties to this action, by their respective undersigned attorneys, that the Court grant defendant leave, pursuant to Rules 13(e) and 15(d) of the Federal Rules of Civil Procedure, to file a counterclaim against plaintiffs (a copy of which is attached hereto as Exhibit A) by supplemental pleading, for the reasons: that the events giving rise to the claim set forth therein have happened since the date of defendant's answer; that the claims asserted in the complaint and the claim asserted in defendant's counterclaim involve a common question of fact and law; that the issue raised by said counterclaim is integrally related to and its proper resolution is dependent upon the disposition of the issue raised by the original pleadings herein; and that it is in the interest of justice that all issues between plaintiffs and defendant be litigated in this action. Plaintiffs will serve their reply to said counterclaim within twenty (20) days after service of a copy of said counterclaim upon them.

Dated: Apr. 28, 1967

CECIL F. POOLE
United States Attorney
By: John M. Youngquist
JOHN M. YOUNGQUIST
Assistant United States Attorney
Attorneys for Defendant

STARK & CHAMPLIN
By: John F. Banker
JOHN F. BANKER
Attorneys for Plaintiffs

Approved and So Ordered:

Dated: April 28, 1967

/s/ Alfonso J. Zirpoli
ALFONSO J. ZIRPOLI
United States District Judge

IN THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF CALIFORNIA

[Caption Omitted]

Civil No. 45575
Counterclaim of Defendant

In counterclaim against the plaintiffs GEORGE W. SOROKOWSKI and NADIA SOROKOWSKI, the defendant UNITED STATES OF AMERICA alleges:

1. This counterclaim is made upon the authorization and direction of duly-appointed delegates of the Secretary of the Treasury of the United States and of the Attorney General of the United States, pursuant to Section 7401 of Title 26, United States Code.

2. Jurisdiction of the subject matter of this counterclaim is conferred upon this Court by Sections 7402(a) and 7405(b) of Title 26, United States Code.

3. This counterclaim is timely made within the period of limitation prescribed by Section 6532(b) of Title 26, United States Code.

4. On or about November 10, 1966, representatives of defendant's District Director of Internal Revenue at San Francisco determined, after reexamination of the plaintiffs' taxable year of 1963, that plaintiffs' federal income tax liability for said year had been overassessed and overpaid in the amount of $3,298.58. On or about December 6, 1966, plaintiffs were given notice of said determination by letter in behalf of said Director mailed to them in care of their attorneys of record.

5. The reason for the determination of the overassessment referred to in paragraph 4 above, was the allowance by said Director of an additional deduction from plaintiffs' taxable income theretofore determined for 1963, which deduction was allowed under Section 165 of the Internal Revenue Code of 1954 (Title 26, United States Code) as a loss in respect of the forfeiture in 1963 by the plaintiff Nadia Sorokowski of rights to moneys totalling $6,797.32, which moneys had been previously taxed to plaintiffs in their taxable years 1960 through 1963 as a portion of said Nadia Sorokowski's share of partnership income of that certain partnership of physicians doing business as the

"Permanente Medical Group" of which she was a partner during said years.

6. During the month of September 1963, the plaintiff Nadia Sorokowski terminated her membership in the partnership referred to in paragraph 5 above, and by said termination she forfeited all rights to moneys theretofore accumulated to her account as a participant and beneficiary under that certain trust know as the "Permanente Medical Group Retirement Plan" established in 1959 by agreement between said partnership and the Kaiser Foundation Health Plan, Inc., and the Bank of America National Trust and Savings Association. It was in respect of said forfeiture of said plaintiff's rights under said trust that the determination as described in paragraphs 4 and 5 above was made in behalf of defendant's said District Director.

7. On or about March 8, 1967, defendant's said District Director mailed to plaintiffs his formal notice of the adjustment made to their 1963 tax liability in respect of the determination referred to in paragraph 4 above, together with United States Treasury Check No. 57,128,129 drawn payable to the order of plaintiffs in the face amount of $3,875.31 in refund of the determined overpayment of tax and interest for said year plus statutory interest payable thereon.

8. The legal correctness of the refund made to plaintiffs in behalf of defendant as set forth in paragraph 7 above is dependent upon the final adjudication of the claims for the taxable years 1960 through 1963 asserted by plaintiffs in their complaint in this action. To wit: if plaintiffs' claims against defendant herein are found and concluded by the Court to be correct, then it will necessarily follow that defendant's said refund paid to plaintiffs be found and concluded to be erroneous and should be ordered set off against plaintiffs' said claims in determining the amount of the judgment against defendant to which they might otherwise be entitled herein; if plaintiffs' said claims are found and concluded to be erroneous, then defendant's said refund to plaintiffs will necessarily be found and concluded to have been correctly made and relief need not be granted on this counterclaim. This counterclaim is thus protective of defendant's rights under its legal position at issue in this action and is contingent upon the resolution of the primary question (the issue joined by the original pleadings herein) of whether moneys paid into the trust referred to in paragraph 6 above by the Kaiser Foundation

Health Plan, Inc., and therein allocated to the account of the plaintiff Nadia Sorokowski constituted income to the partnership of which she was a member and thereby constituted income taxable to her in each of the years in which such sums were so paid in and allocated.

WHEREFORE, the defendant United States of America prays in the alternative:

A. That if the Court finds and concludes that plaintiffs' claims in this action are correct as a matter of fact and law, the Court thereupon find and conclude that defendant's refund paid to plaintiffs in 1967 in respect of their taxable year 1963 as hereinabove alleged was erroneous and order and adjudge that the amount of said refund be set off against said claims of plaintiffs in determining the amount of the judgment for plaintiffs; or

B. That if the Court finds and concludes that plaintiffs' claims are erroneous as a matter of fact and law, the Court thereupon find and conclude that defendant's said refund to plaintiffs was correct and order and adjudge that plaintiffs take nothing on their complaint and that defendant take nothing on this counterclaim; and

C. That defendant have and recover its costs in this action and such other and further relief as the Court deems just and equitable in the premises.

CECIL F. POOLE
United States Attorney
By: /s/ John M. Youngquist
JOHN M. YOUNGQUIST
Assistant United States Attorney

CERTIFICATE OF SERVICE BY MAIL

This certifies that a copy of the foregoing Counterclaim of Defendant was this date mailed to Stark & Champlin, the attorneys of record for plaintiffs, addressed to 1100 Financial Center Building, Oakland, California 94612.

Dated: May 3, 1967

/s/ John M. Youngquist
JOHN M. YOUNGQUIST
Assistant United States Attorney

UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF CALIFORNIA
SOUTHERN DIVISION

[*Caption Omitted*]

Civil No. 44352

Civil No. 44353

Civil No. 44354

Civil No. 44355

Civil No. 44356

Civil No. 45575

STIPULATION AND ORDER FOR CONSOLIDATION OF ACTIONS

IT IS HEREBY AGREED AND STIPULATED by and between the above named parties to the above entitled actions, by their respective undersigned attorneys, as follows:

1. That said actions, including *George W. Sorokowski and Nadia Sorokowski v. United States of America*, No. 45575, are each civil actions for the refund of internal revenue taxes paid by the plaintiffs and that each action is related to each of the others in that each involves similar questions of fact and one common question of law—to wit: whether certain payments made by the Kaiser Foundation Health Plan, Inc., to a trust established pursuant to a certain trust agreement between said Health Plan and a limited partnership of physicians known as The Permanente Medical Group constituted income includible in the gross incomes of the plaintiffs under the Internal Revenue Code of 1954 for the taxable years at issue in said actions;

2. That consolidation of *George W. Sorokowski and Nadia Sorokowski v. United States of America*, No. 45575 with the above captioned actions for trial and for purposes of all proceedings heretofore or hereafter had in said actions will tend to avoid unnecessary costs and delay, will not prejudice any party and will substantially expedite justice in each and all of said actions; and

3. That said actions, including *George W. Sorokowski and Nadia Sorokowski v. United States of America*, No.

45575, therefore be consolidated for all purposes by order of the Court.

Dated: March 8, 1967

STARK & CHAMPLIN
By John F. Banker
JOHN F. BANKER
Attorneys for all Plaintiffs

CECIL F. POOLE
United States Attorney
By John M. Youngquist
JOHN M. YOUNGQUIST
Assistant United States Attorney
Attorney for Defendant

ORDER

The Court having duly considered the foregoing stipulation of the parties to the above entitled actions and approving said stipulation, it is hereby

ORDERED that said actions be and the same hereby are consolidated for all purposes, including discovery heretofore or hereafter undertaken in said actions, pre-trial, trial and all other proceedings.

Dated: May 8, 1967

/s/ Alfonso J. Zirpoli
ALFONSO J. ZIRPOLI
United States District Judge

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA

[Caption Omitted]

Civil No. 45575
Answer to Counterclaim

Come now the plaintiffs, George W. Sorokowski and Nadia Sorokowski, and for answer to defendant's counterclaim herein, admit, deny and allege as follows:

1. Admit the allegations of paragraphs 1, 2 and 3.

2. Plaintiffs have no information or belief sufficient to enable them to answer the allegations of paragraph 4, and basing their denial on that ground, deny each and every allegation therein contained, except that plaintiffs admit that defendant gave them notice of a proposed refund by letter mailed to them in care of their attorneys of record on or about December 6, 1966.

3. Answering paragraph 5, plaintiffs admit that the amount of the "additional deduction" allowed by the District Director of Internal Revenue was equal to the amount of moneys previously taxed to plaintiffs, as a result of notices of deficiency in income tax which are the basis for plaintiffs' complaint for refund of taxes overpaid for the taxable years 1960 through 1963. Except as herein admitted, plaintiffs deny each and every, all and singular, the allegations contained in paragraph 5 and particularly deny that "the reason for the determination of the overassessment" was as stated in paragraph 5.

4. Answering paragraph 6, plaintiffs admit that during the month of September, 1963 the plaintiff Nadia Sorokowski terminated her membership in the Permanente Medical Group Partnership. Except as specifically admitted, plaintiffs deny each and every allegation contained in said paragraph 6, and plaintiffs specifically deny that any moneys whatsoever had "accumulated to" the account of plaintiff Nadia Sorokowski as a participant and beneficiary under that certain trust known as the Permanente Medical Group Retirement Plan; and plaintiffs further allege that the interest of plaintiff Nadia Sorokowski in said Permanente Medical Group Retirement Plan as of the time her membership in the Permanente Medical Group partnership

terminated, was non-vested, contingent, inchoate and wholly uncertain. Hence plaintiff forfeited a mere inchoate expectancy by the termination of her membership in said partnership and did not forfeit "all rights to moneys theretofore accumulated to her acount."

5. Answering paragraph 7, plaintiffs admit that the check therein referred to was transmitted to plaintiffs on or about March 8, 1967, and allege that said check was deposited in trust as more fully described in the letter of plaintiffs' counsel dated May 5, 1967 to the United States Attorney, a copy of which is attached herewith, designated Exhibit "A" and by this reference incorporated herein.

6. Answering paragraph 8, plaintiffs allege that they were not entitled to the said refund, that said refund was erroneous, and that in determining the amount of judgment to which plaintiffs are entitled as against defendant, the said refund should be determined to be a set-off in favor of defendant. Except as herein alleged, plaintiffs deny each and every, all and singular, the allegations contained in said paragraph 8.

WHEREFORE, plaintiffs pray judgment as follows:

1. That the court find and conclude that plaintiffs' claims in this action as stated in the complaint are correct as a matter of fact and law and that the court find and conclude that the said refund hereinabove referred to was erroneous, and order and adjudge that the amount of said refund be set-off against said claims of plaintiffs in determining the amount of the judgment for plaintiffs.

Dated: May 8, 1967.

STARK & CHAMPLIN
By John F. Banker
JOHN F. BANKER
Attorneys for Plaintiffs

May, 5, 1967

Cecil F. Poole
United States Attorney
450 Golden Gate Avenue, Box 36055
San Francisco, California 94102

Attention John M. Youngquist
Assistant United States Attorney

Dear Mr. Youngquist:

Sorokowski v. United States
Civil No. 45575

We have received United States Treasury check No. 57,128,129 drawn payable to the order of George W. and Nadia Sorokowski in the amount of $3,875.31, and representing a purported refund of income taxes for the year 1963. As you are aware, we believe that such refund for 1963 was made in error, and that the Sorokowskis are entitled to recover only the sums requested in their pending suit for refund of income taxes, for the years involved in that suit, and for the reasons therein alleged. Accordingly, we have deposited said check in a trust account pending a final judgment in the above action. If you prefer, we will be happy to return the money immediately so that the United States may retain it during the pendency of the above action.

We frankly do not understand why this check was issued in the first place. It represents a refund which the Sorokowskis have never claimed, and to which they do not believe they are entitled. We were certainly not aware that it was the general policy of the United States to volunteer such unsolicited refunds of income taxes.

Cordially yours,
STARK & CHAMPLIN
By John F. Banker

JFB: bbc
cc: District Director, Internal Revenue Service

EXHIBIT A

CERTIFICATE OF SERVICE BY MAIL

I am a citizen of the United States and am employed in the County of Alameda, State of California. I am over the age of eighteen years and not a party to the within action. My business address is c/o Stark & Champlin, Financial Center Building, Oakland, California 94612.

On May 11, 1967 I served the within

ANSWER TO COUNTERCLAIM

by placing three true copies thereof, enclosed in a sealed envelope with postage thereon fully prepaid, in a United States post office mailbox at Oakland, California, addressed as follows:

Cecil F. Poole
United States Attorney
450 Golden Gate Avenue
San Francisco, California 94102

Executed on May 11, 1967, at Oakland, California.

I certify under penalty of perjury that the foregoing is true and correct.

/s/ Beryl B. Clawson
BERYL B. CLAWSON

IN THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF CALIFORNIA

[*Caption Omitted*]

Consolidated Actions

Civil No. 44352

Civil No. 44353

Civil No. 44354

Stipulation for Presentation of Cases as Short Cause Under Rules 7 & 9, and Agreed Statements of Facts and Issue

Civil No. 44355

Civil No. 44356

Civil No. 45575

IT IS HEREBY AGREED AND STIPULATED by and between the parties in the above-entitled consolidated actions, by their respective undersigned attorneys, as follows:

I

1. These consolidated actions shall be submitted to the Court for adjudication without pre-trial proceedings, pursuant to Rules 7 and 9 of the Court's Rules of Civil Practice, upon the Agreed Statement of Facts and Statement of Issue hereinbelow set forth in final and complete form, upon the exhibits attached hereto, and upon written briefs to be filed with and oral argument to be heard by the Court as hereinbelow agreed.

2. Plaintiffs and defendant shall simultaneously serve and file their opening trial briefs within forty-five (45) days after the filing of this stipulation. Supplemental or reply briefs shall be served and filed in accordance with the Court's direction after hearing.

3. The defendant shall, within forty (40) days after the filing of this stipulation, apply to the Court's Calendar Judge to set these consolidated actions for hearing on the Short Cause Section of the Civil Trial Calendar at a date and time certain at least fifty (50) days following the filing of this stipulation.

II

AGREED STATEMENT OF FACTS

The parties agree that the following stated facts (together with evidentiary exhibits referred to and identified herein and attached hereto) are relevant and material to the resolution of the controversy between all plaintiffs and defendant presented in these actions. This statement of facts is complete, and there are no material issues of fact remaining in dispute. It is further agreed that the attached exhibits, which are photocopies of original documents, be received in evidence with the same force and effect as original documents. This statement and the exhibits submitted shall govern the course of decision in these actions unless amended by order of the Court upon application of a party or parties in order to prevent manifest injustice.

1. The plaintiffs in No. 44352, JAMES A. BASYE and EVELYN E. BASYE, were husband and wife during the years in question in their case (calendar years 1960 and 1961), resided in Alameda County, California, and filed timely joint returns of their federal income taxes for said years with the defendant's District Director of Internal Revenue at San Francisco.

2. The plaintiffs in No. 44353, JACK J. COOK and CAROL LYNN COOK, were husband and wife during the year in question in their case (calendar year 1961), resided in Contra Costa County, California, and filed a timely joint return of their federal income tax for said year with the defendant's District Director of Internal Revenue at San Francisco.

3. The plaintiffs in No. 44354, MAURICE C. FISHLER and PHYLLIS H. FISHLER, were husband and wife during the years in question in their case (calendar years 1960 and 1961), resided in Alameda County, California, and filed timely joint returns of their federal income taxes for said years with the defendant's District Director of Internal Revenue at San Francisco.

4. The plaintiffs in No. 44355, HENRY DONALD GRANT and JEAN M. GRANT, were husband and wife during the years in question in their case (calendar years 1960 and 1961), and resided in Alameda County, California. They each filed a timely return of their respective separate federal income taxes for 1960 and they together filed a timely joint return of their federal income tax for 1961

with the defendant's District Director of Internal Revenue at San Francisco.

5. The plaintiffs in No. 44356, WILLIAM S. HUNTER and JESSAMINE S. HUNTER, were husband and wife during the years in question in their case (calendar years 1960 and 1961), resided in San Francisco, California, and filed timely joint returns of their federal income taxes for said years with the defendant's District Director of Internal Revenue at San Francisco.

6. The plaintiffs in No. 45575, GEORGE W. SOROKOWSKI and NADIA SOROKOWSKI, were husband and wife during the years in question in their case (calendar years 1960, 1961, 1962, and 1963), resided in San Francisco, California, and filed timely joint returns of their federal income taxes for said years with the defendant's District Director of Internal Revenue at San Francisco.

7. Each of these consolidated actions was commenced in this Court by the respective plaintiffs seeking judgment against defendant for the refund of certain sums which plaintiffs claim to have overpaid to defendant in respect of their federal income taxes for the tax years in question. Before commencing these actions, all of the respective plaintiffs filed with defendant's District Director written claims for refund of the sums claimed to have been overpaid within two years after their respective payments of the disputed sums. Those claims for refund were in due course each rejected by the Director by written notices mailed to the respective plaintiffs, and the complaints in these actions were each filed within two years after plaintiffs' receipts of said notices.

8. The claimed overpayments in each case cover taxes and interest paid by the respective plaintiffs after examinations and determinations were made by defendant's Commissioner of Internal Revenue in each case as to deficiencies in the taxes returned by the plaintiff-taxpayers for each of the years involved. The tax deficiencies determined by the Commissioner and the overpayments claimed by the plaintiffs arose out of factual circumstances which are common to each of these consolidated cases.

9. It is agreed that all procedural and administrative requirements under the Internal Revenue Code of 1954 were met and satisfied in each case with respect to examination, determination, notice, protest, administrative review, assessment and collection of the tax deficiences in-

volved, and that the sole and common controversy presented in each of these consolidated actions is whether or not the administratively-determined tax deficiencies are erroneous.

10. The following plaintiffs are each holders of the degree of Doctor of Medicine and were each, during the years involved in their respective cases, practicing physicians duly licensed to practice medicine in the State of California: JAMES A. BASYE, CAROL LYNN COOK, MAURICE C. FISHLER, HENRY DONALD GRANT, WILLIAM S. HUNTER, JESSAMINE S. HUNTER, and NADIA SOROKOWSKI. (These plaintiffs are hereafter sometimes collectively referred to as the doctors.)

11. The doctors were each, during the years involved in their respective cases, general partners in a limited partnership of physicians organized in 1949 to practice medicine in the State of California under the name of "The Permanente Medical Group" (hereafter sometimes referred to as Medical Group or the partnership). The terms of the partnership are all set forth in and controlled by the Articles of Partnership in effect during the years involved in these cases, a true copy of which is attached hereto as *Exhibit A*. The partnership used the accrual method of accounting and filed federal partnership information returns of income on a fiscal year basis ending June 30th during the periods involved in these cases.

12. Prior to the years involved in these cases, The Permanente Medical Group contracted with Kaiser Foundation Health Plan, Inc., a California nonprofit corporation (hereafter sometimes referred to as Health Plan), to provide medical services to members of Health Plan in its Northern California Region. Health Plan operates a contractual membership program providing pre-paid hospital and medical care to its dues-paying members in California and other regions of the Western United States. In order to provide medical services to members in its Northern California Region, Health Plan contracted in writing with Medical Group for the services of physicians to be provided exclusively by Medical Group. The written contract between Health Plan and Medical Group which was in effect for the years in question in these cases is entitled "Medical Service Agreement/Northern California Region/July 1959—June 1961," and a true copy is attached hereto as *Exhibit B*. During the fiscal year ended June 30, 1960, the

Health Plan had approximately 359,000 dues-paying members in its Northern California Region entitled to medical services under their membership contracts, and Medical Group had approximately 205 physician-partners and approximately 41 physician-employees of the partnership.

13. As well as contracting for basic compensation to be paid by Health Plan to Medical Group for medical services (Ex. B, Art. H, pp. 27-29), the parties contracted in the medical service agreement for Health Plan to make payments to a Medical Group "savings and retirement plan or other deferred compensation plan approved by Health Plan" (Ex. B, § H-4, p. 29). On or about December 30, 1959, effective as of July 1, 1959, a "Retirement Plan for The Permanente Medical Group" was established by agreement among Health Plan, Medical Group and the Bank of America National Trust and Savings Association, as trustee. The plan resulted from negotiations between Health Plan and Medical Group and was not unilaterally established by Medical Group. The plan was fully integrated and embodied in a written agreement, entitled "Trust Agreement/Retirement Plan for The Permanente Medical Group," a true copy of which is attached hereto as *Exhibit C*.

14. While the trust agreement itself (*Exhibit C*) and the medical service agreement (Exhibit B) are offered herewith as the best evidence of their provisions, the parties submit herewith for the Court's convenience, as Appendix I hereto, a copy of a summary description of the trust provisions and operation.

15. In entering into the contractual arrangements described in paragraphs 12 and 13 above, Health Plan and Medical Group were separate organizations independently contracting with one another at arms' length. For purposes of the present controversy, it is agreed that Health Plan and Medical Group remained independent contractors during all of the years in question, and that none of the participants in the retirement plan were employees of Health Plan.

16. The primary purpose of the retirement plan was to create an incentive for physicians to remain with Medical Group, or other groups of physicians contracting to serve Health Plan members, and thus to insure Health Plan that it would have a stable and reliable group of physicians providing medical services to its members with a minimum

of turn-over. The retirement plan was patterned after one previously established in Southern California between Health Plan and a partnership of physicians serving Health Plan members in its Southern California Region. The payments which Health Plan agreed to, and did make to the trust, were paid solely to fund the retirement plan, and were not otherwise available to Medical Group or to the individual members or employees thereof.

17. The trust embodying the retirement plan was established during the partnership's fiscal year ended June 30, 1960, upon the trustee receiving and accepting an initial payment from Health Plan. The trust utilized a cash method of accounting on a fiscal year ending June 30th. All payments made to the trust during the years in question (other than income earned on the trust corpus) were made directly by Health Plan and were made in accordance with the provisions of the medical service agreement (*Exhibit B*) and the trust agreement (*Exhibit C*) and not otherwise. No payments were made to the trust during the years in question by Medical Group or by individual participants in the retirement plan.

18. The participants in the retirement plan during the years in question comprised all partners of the Medical Group partnership plus a number of physicians employed by Medical Group who were not members of the partnership.

19. The following schedule sets forth, for each of the years in question (column (a)), the payments accrued and received by the trust from Health Plan (column (b)), the net earnings realized by the trust on its corpus (gross income earned on corpus adjusted for trust expenses) (column (c)), and the total increment in trust funds for each fiscal year:

(a) Fiscal Year Ended	(b) Payments of Health Plan to Trust	(c) Net Earnings on Trust Corpus	(d) Total Increment In Trust Funds Each Year
6/30/60	$ 516,298.68	$ 2,159.74	$ 518,458.42
6/30/61	573,924.60	3,355.79	577,280.39
6/30/62	606,866.28	30,290.56	637,156.84

6/30/63	*$ 315,660.60	$26,097.00	$ 341,757.69
4-Year Totals:	$2,012,750.16	$61,903.09	$2,074,653.25

20. Upon examination of the partnership returns of income filed by Medical Group for its fiscal years ended June 30, 1960 through 1963, defendant's District Director of Internal Revenue at San Francisco made an administrative determination that the partnership income stated therein should be increased by the sums of Health Plan's payments to the trust and trust earnings for the respective fiscal years in the amounts as set forth and explained in paragraph 19 above. The Director made a further administrative determination that such increased partnership income was taxable as income to the individual partners comprising Medical Group for each calendar year in which the partnership fiscal year ended. Thereafter, defendant's Commissioner of Internal Revenue affirmed and caused deficiencies to be assessed in the respective individual income taxes of each of the partners of Medical Group (including plaintiff-partners here), by allocating to each partner a portion of such increased partnership income. Attached hereto and submitted as *Exhibit D* in evidence is a two-page schedule setting forth (first page) how the Director determined and allocated increments in trust funds for each fiscal year in question, and (second page) how the determinations and allocations of increased income were applied in the case of each plaintiff-partner in these consolidated actions.

21. In making the determinations and allocations shown

* For the fiscal year ended June 30, 1963, the actual payment made by Health Plan to the trust was as shown in column (b) above ($315,660.60) and covered accruals for the first six months of that fiscal year. Thereafter, Health Plan made no further actual payments to the trust. Defendant's District Director determined that an additional payment of $324,688.08 was properly accruable from Health Plan to the trust for the second six months of the fiscal year ended June 30, 1963, and proceeded to make the determinations and allocations referred to in paragraph 20 below on the basis of total payments for said fiscal year (actual payments plus accrued payments) in the sum of $640,348.68. The parties in these actions are in disagreement over the question of accrued but unpaid payments to the trust by Health Plan for the fiscal year ended June 30, 1963, and hereby stipulate that such question not be included in the issue to be decided in these actions, and expressly reserve their respective rights, without prejudice to any party, to litigate or settle such issue after the resolution of the issue presented in these actions.

on *Exhibit D* the Director did not take into account the forfeitures by certain participants which occurred during the years here in issue. The participants who did forfeit plan units and the values thereof during said years are set forth in *Exhibit E* attached hereto.

22. The following schedule sets forth in column (d) the tax deficiencies determined and assessed in behalf of defendant in each case with respect to the increased income determined as described in paragraph 20 above and in *Exhibit D* attached hereto. These deficiencies were computed upon the sums shown in column (x) of *Exhibit D*. Plaintiffs paid the assessed deficiencies, together with the interest thereon shown in column (e), on the dates shown in column (f). Plaintiffs each claimed refunds of the total payments thus made (column (g)) and, after completion of the procedures described in paragraphs 7, 8 and 9 above,

(a) Civil No.	(b) Taxpayers	(c) Tax Year	(d) Tax Deficiency Paid	(e) Interest Paid on Tax Deficiency	(f) Date Paid	(g) Total Overpayments Claimed *
44352	Basye	1960	$1,424.02	$ 356.70	6-18-65	$1,780.72
		1961	1,586.93	302.30	6-18-65	1,889.23
						$3,669.95
44353	Cook	1961	$ 301.04	$ 57.35	6-18-65	$ 358.39
44354	Fiehler	1960	$ 660.87	$ 165.54	6-18-65	$ 826.41
		1961	869.67	165.66	6-18-65	1,035.33
						$1,861.74
44355	Grant					
	H.D. (Sep.)	1960	$ 919.76	$ 230.39	6-18-65	$1,150.15
	J.M. (Sep.)	1960	919.76	230.39	6-18-65	1,150.15
	(Joint)	1961	2,236.90	426.12	6-18-65	2,663.02
						$4,963.32
44356	Hunter	1960	$4,094.24	$1,025.57	6-18-65	$5,119.81
		1961	1,630.92	310.68	6-18-65	1,941.60
						$7,061.41
45575	Sobokowski	1960	$ 692.86		4-25-66	
				$ 208.99	5-24-66	$ 901.85
		1961	792.70		4-25-66	
				191.55	5-24-66	984.25
		1962	873.42		4-25-66	
				158.65	5-24-66	1,032.07
		1963	902.69		4-25-66	
				109.80	5-24-66	1,012.49
						$3,930.56

* Statutory interest on any refunds adjudged payable would be calculated on the sums shown in columns (d) and (e) from the dates shown in column (f).

filed these civil actions for refund challenging the defendant's administrative determinations.

23. In Dr. Nadia Sorokowski's case only (No. 45575), the following additional agreed facts are involved. Dr. Sorokowski terminated her membership in the Medical Group partnership in September of 1963. Upon her termination, provisions of the trust agreement became operative whereby she forfeited all rights to receive any future payments from the trust, and the total sum which had been credited to her tentative account in the trust was thereafter reallocated among the remaining participants in accordance with the trust's terms. On or about November 17, 1966, defendant's District Director on his own initiative made an administrative determination that Dr. Sorokowski was entitled to an ordinary loss deduction for 1963 in the amount of the total sum of the increases in income determined and allocated under the trust which had been the basis for the deficiency assessments made against her for the years 1960, 1961, 1962 and 1963. (*Exhibit D*, column (x).) The Director thereupon set up a loss deduction for 1963 in the amount of $6,797.32, and computed that an overpayment of the Sorokowskis' income taxes for 1963 had been made in the amount of $3,298.58. The Director also made an administrative determination that, by reason of Dr. Sorokowski's forfeiture, which occurred in September of 1963, the Medical Group partnership realized additional income for its fiscal year ended June 30, 1964, which then became taxable to the individual partners thereof. On or about March 8, 1967, defendant's Internal Revenue Service issued and mailed to the Sorokowskis a check in the amount of $3,875.31, representing a refund of the overpayment of taxes thus determined for 1963 plus interest thereon. Dr. Sorokowski responded by letter dated May 5, 1967, from her counsel, a copy of which is attached hereto as *Exhibit F*. Defendant filed, on or about May 3, 1967, a protective counterclaim against the plaintiffs-Sorokowski in this case, to which said plaintiffs duly responded, claiming a set-off of the amount thus refunded to plaintiffs in the event it is adjudged by the Court that plaintiffs are entitled to a refund on the common issue involved in these cases.

24. The parties agree that any recomputations of the various sums involved in these actions, which may be required by the Court's adjudication herein, will be made,

verified and settled by counsel. In the event that counsel cannot agree upon such recomputations, the sums may be settled by the Court upon application and ten (10) days notice.

III

AGREED STATEMENT OF LEGAL ISSUE

The parties agree that, upon the foregoing facts, the single issue for decision is:

Whether or not, as a matter of law, Health Plan's payments to the trust and the trust fund earnings constituted income to the partnership which is taxable to the plaintiff-partners for the respective years involved as determined by defendant.

Dated: March 27, 1968

STARK, SIMON & SPARROWE
By: /s/ JOHN F. WELLS
Attorneys for Plaintiffs

CECIL F. POOLE
United States Attorney
By: /s/ John M. Youngquist
JOHN M. YOUNGQUIST
Assistant United States Attorney
Attorneys for Defendant

THE PERMANENTE MEDICAL GROUP RETIREMENT PROGRAM FOR PHYSICIANS

Effective July 1, 1959

APPENDIX I

Retirement Program Definitions

Basic Monthly Compensation Rate

The basic monthly rate of compensation or drawing account payable to a Participant by Medical Group, excluding any contingent compensation or other compensation not regularly paid.

Beneficiary

The person or persons designated by a Participant in writing to receive benefits under the Program at his death prior to retirement or, if no valid designation is effective, his estate.

Committee

The Retirement Committee of seven members appointed to operate the Program and administer it according to its provisions; two members shall be designated by Health Plan, four (of whom at least three shall be Medical Doctors) by Medical Group, and one (a person not directly associated with Medical Group, and preferably one technically qualified by training and experience to advise the remaining members in a technical capacity) by the remaining members of the Committee.

Medical Subcommittee

The Medical Subcommittee of the Committee, consisting of three Medical Doctor members thereof, selected by the Committee.

Health Plan

Kaiser Foundation Health Plan, Inc., (Northern California Region).

Insurer

The life insurance company selected to underwrite the Program.

Medical Group

The Permanente Medical Group, a limited partnership, as may be changed from time to time by the addition of new personnel, by retirement, by reorganization, or otherwise.

Participant

An eligible physician who has elected to participate in the Program.

Trustee

The bank or trust company adopted under the terms of the Trust Agreement.

Facts You Will Want to Know About the Retirement Program

Are You Eligible?

You will be eligible to become a Participant on the July 1st which next follows your completion of two years of Continuous Full-time Association with Medical Group.

If your Continuous Full-time Association with Medical Group began on or before July 1, 1957, you were eligible on July 1, 1959 and may participate as of that date.

Must You Contribute?

No. The full cost of the Program will be met by Health Plan contributions.

How Much Will Health Plan Contribute?

The contributions made by Health Plan will be in accordance with the terms of its Medical Service Agreement with Medical Group. Until changed by the terms of the Medical Service Agreement, Health Plan's contributions will be at the monthly rate of twelve cents (12¢) per subscribing member.

Health Plan's obligation to make contributions in support of the Program is limited to the amounts required by Medical Service Agreements as may now or hereafter be in effect, and the Program does not obligate Health Plan to make any contributions except as specified therein.

What Disposition is Made of the Contributions?

All contributions will be deposited in the Trust. The Trustee is entitled to pay the cost and expenses of Trust administration, and such necessary expenses as the Committee may incur.

The Trust will pay Contributions over to the Insurer, to be held under the terms of a deposit administration contract.

When Will You Retire?

It is anticipated that you will retire at age 65, and the

unit allocation formula for allocating Health Plan's annual contributions to the tentative accounts of Participants is based on that assumption.

However, you may qualify for retirement benefits upon your retirement at any time after completing fifteen years of Continuous, Full-time Association with Medical Group, or at any time upon suffering disability of a substantially permanent nature which, in the opinion of the majority of a panel of three physicians chosen by the Committee, would make it impossible for you to continue a normal medical practice.

How Much Will You Receive When You Retire?

The amount of your retirement income will depend on the amount credited to your tentative account at the time of your retirement and the rate for converting your account into monthly retirement income based on your sex and age at retirement.

How Is Your Tentative Account Determined?

The contributions made by Health Plan are allocated each year among Participants according to a formula based on Basic Monthly Compensation Rates. Consideration is also given to length of prior service and age. The amount so allocated is credited to your tentative account.

At What Rate Will Your Tentative Account be Converted Into Retirement Income?

The rate of conversion will depend upon your sex, age at retirement, and the rates in effect. However, $1,000 will provide approximately $7.00 of monthly retirement income for life to a male age 65, or $6.00 of monthly retirement income for life to a female retiring at age 65.

How Does the Unit Allocation Formula Work?

The unit allocation formula is an attempt to provide equity among Participants so that each one will receive a retirement income at normal retirement proportional to both his Basic Monthly Compensation Rate and his length of Continuous Full-time Association with Medical Group.

The number of units credited to a Participant in a year equals $(A+(A\times B\times C))\times E$ wherein:

"A" represents your salary units—you are credited with one for each $10.00 of your Basic Monthly Compensation Rate.

"B" represents your past service—your years, if any, in excess of two, of Continuous Full-time Association with Medical Group prior to June 30, 1959.

"C" represents your past service unit factor—if you have past service under "B," this factor gives weight to your past service and depends on your age on June 30, 1959.

"E" represents your entry age factor—a factor which gives weight to the number of years you will be covered by the Program and which depends on your age at entry into the Program.

The total units for all Participants are added and divided into the dollar amount of Health Plan's contribution for the year. This gives the dollar value of a unit for that year. The multiplication of the units credited to a Participant by the dollar value of a unit for that year represents the dollar amount to be credited to his tentative account for that year.

At the end of this summary is a table of past service unit factors and entry age factors.

What Conditions Apply to Your Right to Continued Retirement Income Payments?

Your retirement income payments will be discontinued, and your Beneficiary's right to receive any payments at your death will be cancelled, under any of the following circumstances:

1. If, without the prior written consent of the Health Plan, you render professional medical services for any other hospital and medical service plan operated on a group practice prepayment basis within any county in California where Health Plan is operating; or
2. If, while physically fit and legally entitled to practice medicine, and while present within any Health Plan service area you fail or refuse to render consulting serv-

ices when reasonably requested to do so by any medical group practicing in such area and contracting with Health Plan to furnish medical services; or

3. If you fail to comply with such additional conditions as the Medical Subcommittee shall at any time prescribe.

In the event of discontinuance of your benefits under any of the conditions above recited you may, within six months after being so notified, request the Trustee, in writing, to have the facts of your case reviewed by the Committee, whose decision on any such review shall be final and conclusive.

What Happens if You Rejoin Medical Group After Disability Income Payments Commence?

If you are receiving retirement income payments solely on account of disability and subsequently rejoin Medical Group, you may choose between two alternatives:

1. Continue to receive your retirement income payments and be treated in all respects as a physician who has become associated with Medical Group for the first time, requalifying for participation on the July 1st after completing two years of affiliation with Medical Group after rejoining it; or
2. Subject to the Insurer's approval, elect to have your retirement income benefits discontinued and to have the single sum cash equivalent of your anticipated remaining payments restored to your tentative account to increase such benefits as might be subsequently credited thereto.

What Happens at Your Death Before Retirement Income Payments Commence?

In the event of your death before the commencement of retirement income payments the entire amount credited to your tentative account will be applied in such manner as you may during your lifetime have elected in a written election filed with the Committee, either:

1. To purchase an annuity or annuities, at then current rates, for your designated Beneficiary or Beneficiaries; or

2. Paid to your Beneficiary or Beneficiaries in a lump sum; or
3. Paid, with interest, to your Beneficiary or Beneficiaries in equal annual installments over such period not in excess of five years as you shall have designated; or
4. Paid or applied in such other manner as may be permitted under the Insurer's deposit administration contract.

What Optional Forms of Retirement Income Are There?

Prior to your retirement you may elect one of the following alternate forms of payment of retirement income which may be available under the deposit administration contract, subject to such conditions as the contract may stipulate:

1. Reduced payments for life with a guaranteed minimum period of years such as five, ten, fifteen or twenty
2. Reduced payment for life, with the provision that if your wife (or husband) is living on your death, payments will continue in the full amount or in a reduced amount for the remainder of her (his) life. (Of course, any such optional form of payment would necessarily be subject to discontinuance under the same conditions as would cause the discontinuance of payments in the normal form)

What Happens if You Leave Medical Group Before Becoming Entitled to Retirement Income Payments?

If, at the termination of your affiliation with Medical Group (except as the result of your death, or of your disability—See "When Will You Retire?") you have not either:

1. Completed fifteen years of Continuous, Full-time Association with Medical Group, regardless of your age; or
2. Reached your 65th birthday and completed ten but fewer than fifteen years of Continuous, Full-time Association with Medical Group

you will not then or thereafter be entitled to receive any benefits under the Program.

The value of your tentative account in such circumstances will become a forfeiture and will be added to Health Plan's contribution for the year in which your affiliation with

Medical Group is terminated, and allocated with that contribution on the next July 1st to the tentative accounts of physicians then actively participating under the Program.

What Happens if Medical Group is Reorganized or Dissolved, or the Trust Agreement is Terminated?

If Medical Group is reorganized or dissolved and at least 50% in number of its Participants within one year be or become associated with the reorganized Medical Group or with any other Medical Group contracting with Health Plan to provide medical services to Health Plan members, the Program will continue in operation for such Participants, subject to the terms of Health Plan's Medical Service Agreement with such Medical Group. The tentative account of any Participant not included among such 50% of Participants will be forfeited if he has not then qualified for retirement income benefits.

If, in connection with the reorganization or dissolution of Medical Group, Health Plan and Medical Group determine jointly that some other program will best serve to provide retirement benefits for the Participants, Health Plan and Medical Group may jointly instruct the Trustee to transfer the assets of the Trust to another trustee, insurance company or other organization to apply toward funding the benefits under such other program.

In the event of any reorganization, dissolution or other organizational change not described above, all assets held under the Trust Agreement on behalf of Medical Group will be converted to cash; and after reduction by proportionate shares of the expenses of liquidation, the balance of each Participant's tentative account will be paid to him in cash, in one sum.

What Else Should You Know About the Program?

Here are a few further facts worth knowing:

1. Continuous, Full-time Association with Medical Group means your association as an employee or partner devoting substantially full-time to providing medical and necessary administrative services in connection with Medical Group's medical practice, plus time covered by the following periods occurring after such association has begun:

Military service;
Medical research;
Advance study in the field of medicine;
Temporary disability; and
Any other period authorized by Medical Group and approved by the Committee

2. Benefits under the Program cannot be attached by creditors. Neither may you or your Beneficiary in any way transfer your interest in any benefits to any other person or organization.
3. The Committee expects to arrange with the Insurer to provide each Participant with an annual statement showing the dollar value of his tentative account following the close of each fiscal year.
4. You can name or change a Beneficiary by filing with the Committee an original or amended designation, in writing, on forms furnished for that purpose.

How Do You Become a Participant?

To enroll as a Participant, you need only to file in writing with the Committee an election to participate, on a form furnished for that purpose.

CONCLUSION

It is the objective of this summary to give you a description of the Program.

You will understand that this summary is merely descriptive in nature, and that the provisions of the Trust Agreement will be considered as controlling in any case involving a conflict between it and the content hereof.

Copies of the Trust Agreement are available for inspection by any Participant at the Executive Offices of The Permanente Medical Group.

Table of Applicable Factors

Age on June 30, 1959 (for determining "C" factors) and on your entry into the Plan (for determining "E" factors)	Past Service Unit Factors (C)	Entry Age Factors (E)
27	.04	1.000
28	.04	1.036
29	.04	1.073
30	.04	1.113
31	.05	1.154
32	.05	1.199
33	.05	1.245
34	.05	1.295
35	.05	1.348
36	.05	1.404
37	.05	1.465
38	.05	1.513
39	.05	1.566
40	.06	1.621
41	.06	1.680
42	.06	1.743
43	.06	1.812
44	.06	1.885
45	.07	1.966
46	.07	2.052
47	.07	2.148
48	.07	2.148
49	.08	2.148
50	.08	2.148
51	.09	2.148
52	.09	2.148
53	.10	2.148
54	.11	2.148
55	.12	2.148

Age on June 30, 1959 (for determining "C" factors) and on your entry into the Plan (for determining "E" factors)	Past Service Unit Factors (C)	Entry Age Factors (E)
56	.13	2.148
57	.14	2.148
58	.16	2.148
59	.18	2.148
60	.22	2.148
61	.27	2.148
62	.35	2.148
63	.52	2.148
64	1.03	2.148

ARTICLES OF PARTNERSHIP
THE PERMANENTE MEDICAL GROUP

Exhibit A

Copy #——, as amended to July 1, 1957

PERMANENTE MEDICAL GROUP
ARTICLES OF PARTNERSHIP (LIMITED)

WHEREAS, the undersigned desire to enter into a partnership for the practice of medicine;

NOW, THEREFORE, this agreement—

WITNESSETH:

Purpose

Article 1. The parties hereto enter into a partnership for the practice of medicine and for the purpose of affording better aid to the sick and afflicted, encouraging medical study and research and promoting better business administration in the practice of medicine.

Effective Date and Term

Article 2. This agreement shall be effective July 1, 1949, and the partnership shall continue thereafter until terminated, as hereinafter provided.

Principal Place of Business

Article 3. Unless and until hereafter changed, the principal office of the partnership will be at the Kaiser Foundation Hospital, Broadway and MacArthur Boulevard, Oakland, California, at offices leased from the Kaiser Foundation Hospitals. The partnership may also engage in the practice of medicine at Richmond, Vallejo, San Francisco and such other locations in the State of California as may be hereafter selected by the Executive Commitee.

Succession To Predecessor

Article 4. This agreement supercedes that certain agreement between Sidney R. Garfield, M.D., Cecil C. Cutting, M.D., J. Paul FitzGibbon, M.D., Morris F. Collen, M.D., J. Wallace Neighbor, M.D., Robert W. King, M.D., and A. LaMont Baritell, M.D., executed February 21, 1948, providing for the organization of a partnership

for the practice of medicine, and the partnership formed hereby succeeds to and assumes all of the existing business assets and liabilities of the former partnership.

Work of Partners:

Article 5. All of the general partners shall devote all or substantially all of their professional time, effort and abilities to the partnership except as hereinafter provided in this article; all billings and collections for professional services by any and all partners shall be made for the account of the partnership, and all earnings by any of the partners from the practice of medicine subsequent to June 30, 1949, shall belong to the partnership.

Work week, Vacations, Etc.

Unless otherwise provided by the Executive Committee, the regular work week of participation in partnership business for all partners shall not be less than eleven one-half days per week; as partners, vacations shall be two weeks per year during the first two fiscal years, three weeks per year during the third through the seventh fiscal years, and four weeks per year after seven fiscal years; and educational leave shall be one week per year. Absence for vacation, educational leave and sick leave shall be considered as regular participation in partnership business during the period of such absence.

Part Time Partners

It is the desire of the partnership to permit non-partnership research, teaching, business and other personal pursuits to a similar extent as exist in individual private practice, and the Executive Committee shall establish the policies and conditions by which this desire may be effectuated, provided, however, that a partner shall participate in partnership business for at least six one-half days per workweek. Subject to compliance with the conditions and policies established by the Executive Committee, any partner may be absent

from participation in partnership business for such pursuits, provided, however, that such partners shall not have the right to vote on any partnership matter which requires the vote of partners during such period of time as they are not regularly participating in partnership business to an extent of nine one-half days per work-week.

The policies and conditions established by the Executive Committee for these purposes shall have uniform application to all partners and may include the reduction of drawing account, other profit distribution, sick or disability leave, vacation, and capital investment, and the withholding of educational leave and any other partnership benefits and allowances not inconsistent with this agreement.

A partner may be permitted a leave of absence subject to the approval of and conditions established by the Executive Committee.

Capital: General Partners

Article 6. The general partners shall contribute as capital to the partnership the sums hereinafter specified, according to the classification of each respective partner:

Classification	Capital Account
Junior	$ 3,000
Senior	3,750
Division Chief	4,000
Chief of Service	5,250
Physician in Chief Co-Chief Assistant Chief Director	6,750
Executive Director Chief of Staff of Partnership	

Upon any reclassification of a partner, he shall adjust his capital contribution accordingly.

Capital: Limited Partners

Article 7. Each partner classified as a Director or Chief of Staff shall also become a limited partner and shall make an additional capital contribution as a limited partner in the sum of $1,750.

Loans by Partners

Article 8. In the event any partner, either general or limited, furnishes or advances further capital to the partnership, the same shall, unless otherwise agreed upon, be deemed a loan to the partnership.

Division of Profit:

Article 9. The net earnings that may accrue to the partnership during each fiscal year shall be divided as follows:

Limited Partners

a) Each fiscal year in which the net profits do not exceed the aggregate annual drawing accounts of all partners, each limited partner shall receive $600. If the net earnings of the partnership for such year exceed the aggregate annual drawing accounts of all partners plus the first $600 distributed to each limited partner, then each limited partner shall receive an additional $600.

General Partners

b) The balance of the net profits in each fiscal year, after deduction of the sums to be paid to the limited partners, shall be divided between the general partners in the following proportions:

Drawing Accounts

1) Each partner shall first receive an annual drawing account (payable monthly) in the range provided for his classification, the amount within such range to be determined as hereafter provided.

The annual range for each classification is as follows:

Chief of Staff or Directors	$19,890 and upward

Chief of Service, Co-Chief, or Assistant Chief	$12,000 and upward
Division Chief	$11,400 and upward
Seniors	$10,800 and upward
Juniors	$ 7,200 and upward

Said drawing accounts shall be paid in monthly installments and shall be paid only from the net earnings of the partnership. In the event the partnership earnings are insufficient to pay said drawing accounts, they shall be paid proportionately to the extent of the net earnings.

Distribution of Surplus

2) Annual net earnings of the partnership in excess of the aggregate drawing accounts of all partners (after provision for the amounts distributed to limited partners, and other financial obligations to which the partnership is committed until July 1, 1958, to terminate tenure points), shall be distributed equally among the partners.

Division of Losses

Article 10. Losses occurring in any one year up to an amount equal to the aggregate drawing accounts of the partners shall be borne in proportion to the respective drawing accounts of the partners; losses in excess thereof shall be borne equally.

Change in Fiscal Period

Article 11. In the event that the accounting period for the purpose of determining the distribution of net earnings or losses is less than a full year, the amount of annual drawing accounts shall be reduced by the same proportion as the accounting period bears to a full year.

No Compensation

Article 12. No partner shall receive any compensation for acting in partnership business, but his compensation shall be restricted to his distributive portion of the earnings of the partnership.

Bylaws and Powers

Article 13. The general partners may adopt by-laws providing for periodic meetings of the members of the partnership, for the election of officers to preside at such meetings, and for rules for the conduct of such meetings. Action by the partnership as a whole shall be by majority vote, each partner having an equal vote. The partnership as a whole shall determine general policy matters not inconsistent with this agreement. Decisions of the partnership on matters delegated herein to the Executive Committee shall become effective, however, only after approval of the Executive Committee, and nothing in this article shall be deemed to limit the powers of the Executive Committee delegated to them by this agreement.

Executive Committee:

Article 14. In order to carry out the business affairs, management and administration of the partnership, there shall be an Executive Committee consisting of (a) six permanent members and (b) three elected members.

Selection

The permanent members of the Executive Committee shall consist of the following: A. LaMont Baritell, M.D., Morris F. Collen, M.D., Cecil C. Cutting, M.D., M. Friedman, M.D., Robert W. King, M.D., and J. Wallace Neighbor, M.D.

In the event of the death, retirement, or withdrawal of any of the permanent members, the remaining members of the Executive Committee shall, by a three-fourths majority vote, nominate a successor from any of the members of the partnership. Said nomination shall be subject to approval by a majority vote of the partners. If the partners, by a majority vote, do not approve said nomination, the Executive Committee shall, within at least six months, nominate another member.

Elected Members

The three elected members of the Executive Committee shall each be selected from and represent one of the following three districts which are hereby formed for this purpose: District No. 1—Oakland region comprizing all offices of the partnership east of San Francisco Bay except those specified in District No. 3; District No. 2—San Francisco region comprizing all offices of the partnership west of San Francisco Bay; and District No. 3—Walnut Creek and Vallejo and their associated offices. Said elected members shall be elected in the following manner: A nominating committee shall be appointed by the Executive Committee to nominate two or more partners for election to the Executive Committee from each district for which an election is to be held; at the said election meeting any other nominations may be made by any partner, and the partnership shall elect by majority vote the Executive Committee member for each district for which an election is held. The elected members of the Executive Committee shall serve for a term of two years. In the event of the death, retirement, or withdrawal of an elected member, the successor for the unexpired portion of the term of said member shall also be chosen in the foregoing manner.

In the event of a vacancy or vacancies in the membership of the Executive Committee, the remaining members shall have all of the powers vested in the full Committee pending the appointment or election of additional members.

Powers

The Executive Committee shall have full and complete charge of the business affairs, administration and management of the partnership, including but without being limited to the following matters:

1. The making of all contracts, including

contracts with any person or organization for the rendition of professional services, hospitalization and incidental services.

2. The hiring and discharging of all employees of the partnership, except that the Executive Committee shall not make a contract for employment for more than two years without the consent of the majority of all partners.

3. The lease, purchase or other acquisition of property from others or the lease, sale or other disposal of partnership property, except that the Executive Committee shall not enter into a lease for a term of more than two years without the consent of the majority of all partners, nor shall it enter into any transaction for the purchase or sale of property in an amount in excess of $25,000. without the consent of the majority of all partners.

4. The Executive Committee shall also arrange for the purchase of supplies as required in the normal operation of the partnership.

5. The Executive Committee shall meet at least once every two weeks and shall adopt procedures for the conduct of its business.

6. The Executive Committee shall have the right to assign the duties of each partner in accordance with the classifications contained in this agreement. Such classification shall be made at least ten days before the beginning of each fiscal year of the partnership, and shall not be made more than once a year. Ten days before the beginning of each fiscal year, the Executive Committee shall also determine the amount of the drawing account of each partner within the range of his respective classification. In the event the Committee does not take action with respect to the classification or the amount of the drawing account of a partner, such partner shall

continue with the classification or drawing account previously held by him.

7. In the event of the dissolution of the partnership, the members of the Executive Committee holding such office as of the effective date of dissolution, shall have possession and control of all partnership assets for the purpose of winding up the partnership affairs, and shall for such purpose have all powers otherwise vested in the entire partnership.

Controller

Article 15. There shall be a controller of the partnership who shall be responsible for the establishment of proper accounting procedures and for the keeping of the books of the partnership, and who shall determine any questions of accounting that may arise.

The controller is also authorized and delegated the authority to open one or more bank accounts on behalf of the partnership, in the name of "The Permanente Medical Group" or such other name or title as he may designate, and he is authorized to draw, endorse, sign and deposit checks and drafts in the name of and on behalf of the partnership, and to use a facsimile signature therefor.

The Executive Committe shall have the right to remove the controller and appoint a successor, and to withdraw any delegation of authority herein made to the controller, and to designate such other persons to endorse, sign and deposit checks and drafts in the name of an on behalf of the partnership, and to open one or more bank accounts on behalf of said partnership, in such name or title as they shall designate.

Withdrawal, etc.

Article 16. In the event of the death, withdrawal or retirement of a general partner, or limited partner, this partnership shall not be thereby dissolved, but shall be continued by the survivors.

Determination of Interests

The interest of such partner in the partnership shall terminate as of the last day of the calendar month in which his death, withdrawal or retirement occurred, and the value of the interest of such partner in the partnership shall be determined by the Executive Commitee as of such date from the books of the partnership, and such interest as so determined shall be liquidated and the amount thereof shall be paid to such partner or his representatives, if deceased, provided that the partnership shall have the right, at its option, to pay such interest in twelve equal monthly installments, commencing from the time of the determination of the value of such interest. No audit shall be performed for this purpose prior to the close of any fiscal year.

The interest of such partner shall be conclusively determined by the book value of the partner's proportionate share of the capital of the partnership (which share shall be in the same proportion as the amount of capital contributed by him bears to the total amount of capital contributed by all partners), plus such partner's proportionate share of undistributed net earnings for the current year as of the end of the month in which he withdrew, retired or died, and said books shall be conclusive evidence thereof, and each partner, for himself, his heirs, representatives and assigns, agrees that such payment shall be accepted in full satisfaction of any and all claims that he or his heirs or estate may have against this partnership, and in full payment of all of the assets of every kind and description, and that all of his interests in such assets, except as above provided for, shall become the absolute property of the remaining partners upon his death. No value shall be assigned to good will or going value or similar intangibles.

Withdrawal and Retirement: Rights

Article 17. A partner may voluntarily retire or withdraw from the partnership at any time upon thirty days' notice in writing to the remaining partners, and any member may be required to withdraw at any time and for any reason whatsoever when, by at least two-thirds vote, the Executive Committee determines that such withdrawal be required. The retirement age from the partnership shall be sixty-five years, and voluntary retirement shall be permissible at any time between the sixtieth and sixty-fifth birthday, effective at the end of a partnership fiscal year. Compulsory retirement shall be at the beginning of the fiscal year next following the sixty-fifth birthday.

Sick or Disability Leave

Article 18. Every partner, upon admission to the partnership shall be entitled to five and one-half months' sick leave without loss of drawing account and participation in other distributions of partnership earnings. In each year of membership in the partnership subsequent to the first year of membership, a partner shall be entitled to an additional thirty days' sick leave, the unused portions of which may be accumulated from year to year with the unused portion of the original five and one-half months' sick leave period, provided, however, that at no time shall a partner be entitled to greater than five and one-half months' total sick leave. During any absence on sick leave, a partner shall not accrue further sick leave. During any absence for sickness in excess of the sick leave period, a partner shall not receive a drawing account or otherwise share in partnership earnings.

Upon any prolonged disability or illness, a partner who is entitled to sick leave, must elect in writing filed with the Executive Committee within thirty days from the onset of the disability or illness either:

1. To receive one hundred percent of his usual drawing account and participation in other distribution of earnings during such absence but for no longer than five and one-half months. Or

2. To receive one hundred percent of his usual drawing account and participation in other distribution of earnings for the first two months of such absence, fifty percent of such amounts for the next succeeding four months of such absence, and twenty-five percent of such amounts for the following six months of such absence.

After one year's continuous absence by reason of illness or disability a partner shall withdraw from the partnership, but may apply for readmission.

Additional Partners

Article 19. New general partners may be added to this partnership upon the approval of the majority of the Executive Committee and upon a vote of approval by three-fourths of all of the partners, and upon written acknowledgement of such new partner, to be bound by all of the terms and provisions of this agreement, and upon the payment by such new partner of the capital contribution herein provided for.

Termination

Article 20. This partnership may be terminated by a two-thirds vote of the Executive Committee.

Amendments

Article 21. The Articles of Partnership shall be amended by the adoption of any addition or amendment thereto by the written assent or vote at any regular or special meeting of the partnership subsequent to the meeting of the partnership at which said amendment or addition is first proposed, of a majority of all partners and by the vote or written assent of a majority of the Executive Committee at a meeting of the Executive Committee.

MEDICAL SERVICE AGREEMENT
July 1, 1959

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EXHIBIT B

MEDICAL SERVICE AGREEMENT

July 1, 1959—June 30, 1961

LETTER OF UNDERSTANDING

Executed July 15, 1959

AMENDMENT

Executed March 19, 1962
to amend Medical Service Agreement
for July 1, 1959—June 30, 1961,
as amended to cover July 1, 1961-June 30, 1962

MEDICAL SERVICE AGREEMENT

Northern California Region

July 1959—June 1961

KAISER FOUNDATION HEALTH PLAN, INC., a California nonprofit corporation, and THE PERMANENTE MEDICAL GROUP, a limited partnership, hereby agree as follows:

This Agreement consists of the following four parts:

Part I. Definitions and Introductory Provisions
Part II. General Contractual Provisions
Part III. Financial and Administrative Provisions
Part IV. Provisions Relating to Liaison and Cooperation

Part I.

DEFINITIONS AND INTRODUCTORY PROVISIONS

Article A

Definitions

As used in this Medical Service Agreement, the terms set forth in this Article shall have the meanings set forth herein except where from the context it is clear that such meanings are not intended.

Section A-1. Parties to or Affected by Agreement

a. "Medical Group" shall mean The Permanente Medical Group, a limited partnership, whose original Certificate of Partnership was filed with the County Clerk of Alameda County, California, June 29, 1949 in Book 5963 on Page 595.

b. "Physicians" shall mean all licensed physicians who are partners in, or associates or employees of, Medical Group.

c. "Other Personnel" shall mean all personnel other than Physicians engaged by Medical Group to assist in carrying out its responsibilities under this Agreement, including para medical personnel, nurses, and administrative, clerical, maintenance, and miscellaneous classifications.

d. "Attending Physician" shall mean the Physician pri-

marily responsible for the care of a Member with respect to the particular circumstance or condition requiring consideration or the authority or responsibility of an Attending Physician under this Agreement.

e. "Hospitals" shall mean Kaiser Foundation Hospitals, a California nonprofit and charitable corporation, insofar as its operations within the Service Area are concerned.

f. "Health Plan" shall mean the Northern California Region, a separate division of Kaiser Foundation Health Plan, Inc., a California nonprofit corporation.

Section A-2. Health Plan Members and Contracts

a. "Member" shall mean any person entitled to Medical Services pursuant to this Agreement by reason of a Health Plan Membership Contract.

b. "Subscriber" shall mean a Member by whom, or on whose direct behalf, membership dues are paid, and who is thereby entitled to Subscriber Benefits as specified in the applicable Membership Contract.

c. "Dependent" shall mean any Member bearing such relationship to a Subscriber as to be entitled to Dependent Benefits under the applicable Membership Contract.

d. "Membership Contract" shall mean the applicable Individual or Group Contract under which any Member is entitled to Medical Services to be provided by Medical Group pursuant to this Agreement.

e. "Group Contract" shall mean a master Membership Contract under which a number of Subscriber Members, together with their respective Dependent Members, are entitled to Medical Services to be provided by Medical Group pursuant to this Agreement.

f. "Individual Contract" shall mean a Membership Contract under which a single Subscriber Member or a single Subscriber Member and his Dependent Members are entitled to Medical Services to be provided by Medical Group pursuant to this Agreement.

Section A-3. Medical and Hospital Services

a. "Service Area" shall mean all that geographical area in Northern California lying within a radius of thirty (30) miles of any hospital owned or operated by Hospital or any medical offices under the professional supervision of Medical Group and utilized to provide Medical Services under this Agreement.

b. "Hospital Services" shall mean all hospitalization rendered to Members, including such nursing and incidental services as are customarily furnished by acute general hospitals and as are required by the Hospital Service Agreement entered into as of January 1, 1959 between Health Plan and Hospitals.

c. "Medical Services" shall mean all outpatient and inpatient services to Members (excluding Hospital Services) required fully to satisfy all obligations, within the Service Area, of Membership Contracts, or which may be rendered to Members within the Service Area by reason of their Health Plan membership, excluding, however, Private and Industrial Medical Services.

d. "Private and Industrial Medical Services" shall mean:

1. All services rendered by Medical Groups to persons who are not Members of Health Plan; and
2. All professional services for private and industrial patients including revenue derived from compensation insurance companies as a consequence of treating Health Plan Members suffering from an industrial illness or injury; and
3. Such other services rendered by Medical Group to Health Plan Members as may be excluded from the scope of Medical Services as defined in this Agreement by mutual agreement between Health Plan and Medical Group.

Section A-4. Financial and Accounting Matters

a. "Health Plan Revenue" shall mean all revenue actually received by Health Plan from or on behalf of Members pursuant to any provision of any Membership Contract, except as otherwise expressly provided by this Agreement Health Plan Revenue shall include Dues, Registration Fees, Supplemental Charges, and Drug and Miscellaneous Revenue as herein defined.

Health Plan Revenue shall also include the net effect of capital gains or losses resulting from the sale or other final disposition of fixed assets and leasehold improvements acquired by Health Plan for the principal purpose of providing services to Members.

Health Plan Revenue shall not include any sums received in the following categories:

1. Contributions to Capital, as herein defined;
2. Excluded Income, as herein defined;
3. Revenue attributable to Private and Industrial Medical Services, as herein defined, rendered by Medical Group;
4. Medical Review Fees for prospective Health Plan Members;
5. Charges made by Medical Group pursuant to Membership Contracts for house call services (i.e. house call professional fees and injections);
6. Such additional categories of income otherwise within the definition of Health Plan Revenue as may be excluded from time to time by mutual agreement of the parties.

b. "Dues" shall mean periodic payments made by or on behalf of Subscribers pursuant to Membership Contracts.

c. "Registration Fees" shall mean all Health Plan Revenue collected by Health Plan incident to registration of new members.

d. "Drug and Miscellaneous Revenue" shall mean the net effect of operations of Dapite, Incorporated in Northern California determined by consolidating said Dapite operating results with operating results of Health Plan.

e. "Supplemental Charges" shall mean all Health Plan Revenue other than Dues, Registration Fees, and Drug and Miscellaneous Revenue actually received from or on behalf of Members incident to rendition of Medical Services or Hospital Services. Supplemental Charges consist primarily of charges to Members in lieu of comprehensive prepaid Dues, and include:

Office visits, radiology, laboratory, physical therapy, dental X-ray, X-ray therapy, maternity, tonsillectomy, adenoidectomy, operating room, emergency room; and

Charges for transfusions, injections, allergy materials, allergy injections, hearing tests, radioactive isotope studies, hospital room and board, refractions; and

Assigned disability insurance benefits and net recov-

eries to Health Plan in third party responsibility cases; and

Other charges of similar nature now or hereafter made to Members in lieu of comprehensive prepayment.

f. "Contributions to Capital" shall mean any funds or other things of value received by Health Plan as donations, investments, consideration for initial issuance or renewal of Membership Contracts, or otherwise, which are intended and received for capital, rather than income, account. (Contributions to Capital do not constitute Health Plan Revenue).

g. "Excluded Income" shall mean all income received by Health Plan from investments (except for Health Plan's investment in Dapite, Incorporated) and from any other activities not directly or indirectly related to administering Membership Contracts or arranging for Medical and Hospital Services provided to Members. (Excluded Income does not constitute Health Plan Revenue).

h. "Net Health Plan Revenue" shall mean Health Plan Revenue minus all amounts paid or obligations incurred to Medical Group under Article H of this Agreement, all amounts paid or obligations incurred to Hospitals under the Hospital Service Agreement of Jan. 1, 1959, and all expenses paid or incurred by Health Plan incident to its operations in the Northern California Region, excluding, however, such expenses as may be allocable, under sound accounting practice, to the production of Excluded Income.

i. "Additional Compensation" shall mean amounts paid to Medical Group based on Health Plan Net Revenue as provided in Article I.

Section A-5. Facilities and Equipment

a. "Built-in Equipment" shall mean equipment which is an integral part of a building and is usually included in the construction contract.

b. "Movable Equipment" shall mean movable equipment having a unit cost of $50.00 or more, and a useful life of five years or more plus all tables, chairs, desks, files and cabinets regardless of unit cost.

c. "Non-capitalized Equipment" shall mean equipment (not included within the definition of Built-in Equipment or Movable Equipment) having a unit cost of less than

$50.000 and a useful life of less than five years and shall include expendable supplies and equipment.

Section A-6. Matters Relating to Claims

a. "Liability Claims" shall mean all claims asserted against Hospitals or Health Plan or Medical Group arising out of, or allegedly arising out of, acts or omissions occurring or alleged to have occurred after April 9, 1956, and during the term of this Agreement or any extension hereof.

b. "Contractual Claims" shall mean all claims arising, or alleged to have arisen out of the failure of Health Plan to perform its contractual obligations under Membership Contracts or out of the failure of Hospitals or Medical Group to perform their respective obligations under Membership Contracts during the term of this Agreement or any extension hereof.

c. "Mixed Claims" shall mean claims having aspects of both Liability Claims and Contractual Claims.

d. "Out-of-Area Claims" shall mean claims of Members for reimbursement of expenses incurred, or allegedly incurred, by them for Medical or Hospital Services pursuant to provisions of Membership Contracts covering monetary reimbursement for certain services received outside the Service Area.

ARTICLE B

Introductory Provisions

The principal facts and circumstances leading to the execution of this Agreement are as follows:

Section B-1. Nature and Functions of Health Plan

Health Plan is a California nonprofit corporation maintaining a nonprofit hospital and medical service program in California through contractual arrangements with physicians and hospitals; as of the date of this Agreement, approximately 350,000 Members are entitled to the benefits of Health Plan Membership Contracts in the Service Area.

Section B-2. Nature and Functions of Medical Group

Medical Group is a group of licensed physicians organized as a limited partnership for the purpose of carrying

out their practice of the medical profession. In addition to physician members of the partnership, Medical Group employs other physicians and Other Personnel. Medical Group is staffed and otherwise prepared to provide Medical Services to Members in the Service Area.

Section B-3. Mutual Desire to Contract Regarding Medical Services

Health Plan desires to arrange by contract for all Medical Services in the Service Area, required to satisfy, or convenient or incidental in connection with satisfying, the Medical Service obligations provided in Membership Contracts. Medical Group agrees to provide such Medical Services for the consideration and subject to the terms and conditions set forth in this Agreement.

Section B-4. Principles of Payment under Membership Contracts

Dues constitute the basic method of payment for Health Plan services under all Membership Contracts. The method of paying for Medical and Hospital Services through prepaid Dues is in keeping with Health Plan's fundamental principle that budgeting the costs of medical care is beneficial to Members, to Hospitals and Medical Group as providers of services and to the community as a whole.

Health Plan offers various types of Membership Contracts in order to provide for the varying circumstances of, and meet the needs of, different categories of Members. The various types of Membership Contracts differ in the extent to which the Medical Services and Hospital Services arranged by Health Plan are paid for through Dues and through Supplemental Charges; however, in all Membership Contracts, dues constitute the major portion of the payment. The concept underlying all such Contracts is that the Health Plan makes similar total charges for similar categories of benefits, which total charges are, however, divided in different ways between prepaid Dues and Supplemental Charges (which consists of various charges in lieu of prepaid Dues). Although Supplemental Charges in lieu of prepayment are made as an incident to and in connection with the receipt by Members of various Medical Services and Hospital Services, the rendition of such Services by Hospitals and Medical Group is done pursuant to

the requirements of this Agreement and of the Hospital Service Agreement of January 1, 1959 and not in consideration of such Supplemental Charges. Accordingly, such Supplemental Charges do not constitute fees for services, but rather are charges in lieu of prepayment in accordance with the Health Plan's basic principles.

To facilitate applying these underlying principles, it is desirable that all categories of Health Plan Revenue shall be collected by, or for the account of Health Plan, and that Compensation for Medical Services shall be on the same basis for all types of Membership Contracts without being affected by the varying relationships between Prepaid Dues and Supplemental Charges.

Section B-5. Improved Basis of Contracting

Health Plan has heretofore contracted with Medical Group for Medical Services to Health Plan Members on terms similar to those embodied in this Agreement. This Agreement represents the joint efforts of Health Plan and Medical Group to simplify contractual arrangements, stabilize Medical Group revenue, and achieve a more efficient and practical allocation of functions and responsibilities to increase benefits to Members and decrease costs as much as possible consistent with maintaining desirable standards of Hospital Services and of professional Medical Services.

Section B-6. Independence of Contracting Parties

A fundamental feature of Health Plan's nonprofit hospital and medical service program is that the Health Plan and the Medical Group are separate and independent entities. The relations of Health Plan and the Medical Group are purely contractual, and neither Health Plan, nor any employee thereof is the agent, employee, servant or other representative of Medical Group, nor is Medical Group or any Physician or Other Personnel in Medical Group an agent, employee, servant or other representative of Health Plan.

Section B-7. Liaison and Cooperation

As independent contracting parties, Health Plan and Medical Group maintain separate and independent management, and each has full and complete authority and

responsibility regarding its organization and operations. However, the nature of Health Plan's nonprofit hospital and medical service program is such that efficient operation, in the interest of providing comprehensive benefits to Members at the most reasonable cost consistent with desirable standards of Medical Services and Hospital Services, requires continuing and effective liaison and close cooperation between Health Plan and Medical Group. Health Plan and Medical Group mutually intend that, to the fullest extent consistent with separate and independent management, such liaison and cooperation shall be maintained.

Section B-8. Intent to Establish Exclusive and Continuing Relationship

Health Plan and Medical Group believe their best interests and the best interests of Members will be promoted by establishing a stable and continuing relationship in accordance with the principles established by this Agreement, and each party intends to attempt in good faith to continue contractual arrangements upon the expiration of this Agreement generally in accordance with such principles. Health Plan intends to contract for Medical Services exclusively with Medical Group and not to contract for such services with any other physicians in the general area now being served by Medical Group so long as Medical Group shall satisfactorily serve the needs of Health Plan and Health Plan Members. Similarly, Medical Group intends to contract exclusively with Health Plan and not to render professional services pursuant to any other direct service type of prepayment plan within the general area being served by Health Plan so long as its relationship with Health Plan shall satisfactorily serve the needs of Medical Group.

Part II.

GENERAL CONTRACTUAL PROVISIONS

Article C

Arrangements Regarding Medical Services

Section C-1. Medical Services to be Provided

Within the Service Area, Medical Group shall provide to all Members all Medical Services required by or incident

to Membership Contracts. All Medical Services required or provided hereunder shall be of good quality and shall meet the accepted standards of professional medical and surgical practices prevailing in the Service Area at the time such services are rendered.

Medical Group shall be solely responsible for the rendition of all Medical Services pursuant thereto, without intervention in any manner by the Health Plan or its agents or employees. However, Medical Group undertakes that such Medical Services shall be available at such times and places as are necessary and practical for the prompt and proper rendition thereof.

Section C-2. Continuing Responsibility

Membership Contracts in effect in the Service Area provide certain continuing responsibility in the event Health Plan terminates a Membership Contract. A typical provision is as follows:

> "If this Agreement is terminated as to a Subscriber or Family Dependent by the Health Plan, said Subscriber or Family Dependent shall be entitled to continuation of the services set forth in this Agreement for any condition being treated under this Agreement at the effective date of termination, for a period not to exceed one hundred and eighty (180) consecutive days from the date of termination, provided such Subscriber or Family Dependent notifies the Health Plan in writing within thirty (30) days from the effective date of termination that he desires continuation of services for said condition, such notice to set forth the nature of the condition and the name of the attending physician. Upon receipt of such notice, the Health Plan, after consultation with the attending physician, shall provide the Subscriber or Family Dependent with a written statement confirming and defining, or denying, his rights to services during said one hundred and eighty (180) day period."

In addition to other Medical Services to be provided by Medical Group under this Agreement, Medical Group shall provide, within the Service Area, all Medical Services required by, or incident to continuing responsibility provisions in Membership Contracts.

Section C-3. Compensation for Medical Services

As full consideration for rendering Medical Services as required by Sections C-1 and C-2, Medical Group shall receive the compensation provided in Part III hereof; Medical Group shall not make or permit any charge to Members on account of or otherwise incident to Medical Services, except as specifically provided or permitted by applicable Membership Contracts. This Section shall not operate in any manner to restrict Medical Group with respect to charges for Private and Industrial Medical Services.

Section C-4. Limitations on Subcontracting

Medical Group shall not assign or subcontract any part of the performance of Medical Services pursuant to this Agreement to other physicians without the approval of Health Plan; provided, however, that Medical Group may engage services of such consultants and specialists as appropriate in maintaining accepted professional standards of medical care; provided further, that Medical Group may engage the assistance of licensed medical doctors not regularly employed by or otherwise associated with Medical Group for emergency duty, night duty and house calls, in accordance with usual and customary practices in the medical profession in the Service Area, provided that the quality of Medical Services is not adversely affected thereby.

Section C-5. Review of Membership Contracts

a. *Existing Contracts.* Medical Group has reviewed all Membership Contracts in effect as of the effective date of this Agreement, and hereby acknowledges its approval thereof.

b. *Amendments and Modifications.* If Health Plan shall desire to modify or amend existing Membership Contracts, then Health Plan shall submit such proposed amendments or modifications to Medical Group for review a reasonable time in advance of the proposed effective dates thereof. If Medical Group does not approve of any such amendment or modification because it (i) requires or tends to require additional Medical Services within the Service Area, (ii) appears, in the reasonable judgment of Medical Group, to

affect the physician-patient relationship or professional or ethical aspects of Medical Group's practice, or (iii) otherwise tends, in the reasonable judgment of Medical Group, to affect adversely the interests of Medical Group, then Medical Group shall so notify Health Plan in writing within thirty (30) days after receipt of such proposed amendment or modification; no amendment or modification of existing Membership Contracts which Medical Group has disapproved as above provided shall be binding on Medical Group.

If Medical Group shall desire to modify or amend existing Membership Contracts, it may submit its proposed amendments or modifications to Health Plan for review and discussion. Health Plan shall endeavor to cooperate with Medical Group in effecting amendments or modifications proposed by Medical Group. However, no such amendment or modification shall take effect until approval thereof by Health Plan and compliance with all necessary procedures and formalities required or deemed desirable by Health Plan in maintaining proper relationships with the Members affected thereby.

c. *Renewal or Extension of Existing Contracts.* Health Plan may, without prior review or approval of Medical Group, renew or extend existing contracts unless Medical Group shall, at least sixty (60) days prior to the time at which Health Plan is required to give notice of amendment, modification or termination, notify Health Plan that Medical Group desires that such contracts be amended, modified or terminated. If Medical Group so notifies Health Plan, Health Plan will cooperate with Medical Group in an effort to arrive at a mutually satisfactory disposition of Medical Group's request. However, nothing contained in this subsection C-5-c shall prevent Health Plan from renewing or extending existing contracts without amendment or modification if Health Plan deems such action necessary or desirable.

d. *Changes in Dues or Supplemental Charges.* The handling of changes in rates charged to Health Plan Members, either through prepaid Dues or Supplemental Charges, is governed by Section L-5, and changes affecting only the amount of prepaid Dues or Supplemental Charges shall not be deemed to constitute amendments or modifications within the meaning of this Section C-5.

Section C-6. Review of Additions to Membership

Health Plan and Medical Group mutually desire that, so long as Medical Group is providing Medical Services to all persons entitled to the benefits of Health Plan coverage within the Service Area, total enrollment shall be controlled to avoid exceeding the reasonable capacity of available personnel and facilities. However, growth of Health Plan membership is not entirely within the control of Health Plan. To the end that membership growth may be limited insofar as practical consistent with existing commitments:

a. *Additions to Existing Groups.* Under many Health Plan Group Contracts additional persons in the group covered by such contracts are entitled to Health Plan membership without review or approval, either by Health Plan or Medical Group; Medical Group is responsible under this Agreement to provide Medical Services to additional persons entitled to enroll under such Group Contracts. Health Plan will, however, use its best efforts, insofar as consistent with its commitments, to limit additional enrollment under existing Group Contracts in those situations in which such additional enrollment would tend to cause an excessive burden on available facilities or would tend to affect adversely the standard of professional care being rendered.

b. *Transfers from Group to Individual Membership.* Under many Health Plan Group Contracts, Members whose affiliation with the group is for any reason terminated are entitled to continue their membership under an Individual Contract; similarly, under many Individual and Group Contracts, Dependants, upon attaining a certain age, are entitled to continue their membership under their own Individual Contracts. In all such cases, Medical Group is responsible, under this Agreement, to provide Medical Services to existing Members who exercise their contractual rights to continue their memberships.

c. *New Individual Enrollments.* Additional persons desiring to enroll under Individual Contracts shall be subject to medical review by Medical Group, and Health Plan will not enroll any persons as Members who fail to qualify for membership under such medical review; nor will Health Plan effect any additional enrollments under circumstances in which, in Medical Group's opinion, such additional enrollments are apt to cause an excessive burden on available facilities or on Medical Group.

d. *New Group Enrollments.* If Health Plan desires to enroll one or more additional groups under a Group Contract of any type now in effect, or any amendment or modification thereof, Health Plan shall advise Medical Group regarding the terms of the proposed contract and of the estimated number of new Members to be enrolled. If Medical Group does not approve of such proposed new enrollment, either by reason of number of prospective new Members or by reason of the terms of the proposed contract, Medical Group shall so advise Health Plan in writing within thirty (30) days after receipt of notice; Medical Group shall have no obligation under this Agreement to provide Medical Services to new Members enrolled by Health Plan if Medical Group so advises Health Plan of its disapproval.

Section C-7. Limitations on Disapproval.

Medical Group shall use its best efforts to accommodate contract changes, if any, proposed by Health Plan pursuant to Section C-5-b and to provide Medical Services, as required, to permit normal growth and enrollment of additional Members pursuant to Section C-6; and Medical Group shall not unreasonably withhold its approval of contract changes or the enrollment of new Members under Individual or Group Contracts.

Section C-8. Personnel and Equipment to be Provided by Medical Group.

Within the Service Area, Medical Group shall provide, at Medical Group's expense, all Physicians and Other Personnel and all Non-Capitalized Equipment reasonably required for full and satisfactory performance of all Medical Services (except that Health Plan shall provide such Non-Capitalized equipment as the parties hereto shall mutually agree upon) and shall bear all expenses, required or incurred in connection with conducting Medical Group's practice, including expenses incident to providing Physicians, Other Personnel, facilities, equipment, and medical and administrative services, except to the extent that Health Plan, under this Agreement, expressly undertakes to provide facilities, equipment or services or incur expenses. Medical Group shall provide all personnel and facilities and bear all expenses relating to Private and

Industrial Medical Services, except to the extent that facilities or services incident to Private and Industrial Medical Services are to be provided by Health Plan under this Agreement.

Under the Hospital Service Agreement entered into as of January 1, 1959 between Health Plan and Hospitals, Hospitals is required to provide all Hospital Services, together with facilities, personnel and equipment reasonably required for the full and satisfactory performance thereof, and it is understood that this Section C-8 does not require Medical Group to provide hospital personnel, facilities or equipment.

Article D

Relations Between Physicians and Members

Section D-1. Physician-Patient Relationship.

Physicians shall maintain the relationship of physician and patient with Members, without intervention in any manner by Health Plan or its agents or employees, and Physicians shall be solely responsible for all medical advice to, and treatment of Members and for the performance of all Medical Services, within the Service Area in accordance with accepted professional standards and practices.

Section D-2. Termination of Untenable Relationships.

Health Plan and Medical Group recognize that the physician-patient relationship is a personal relationship and involves a professional responsibility, and that circumstances may arise under which relations between particular Members and particular physicians may become unsatisfactory. In such cases Medical Group will use its best efforts to provide Physicians who may develop a satisfactory physician-patient relationship with such Members; if Medical Group is unable to do so, then Health Plan, upon written request from Medical Group will use its best efforts to terminate the membership of any such Member as promptly as reasonably possible.

Article E

Relation of Health Plan with Members and the Public

Health Plan recognizes that legal provisions and pro-

fessional ethical standards relating to the practice of medicine prohibit advertising or solicitation by physicians, and that Physicians wish to conduct their practice in an entirely lawful manner and avoid any actions which might appear inconsistent with professional standards of medical ethics; it is understood, in this connection, that Health Plan is an independent contractor and that neither Health Plan nor any of its employees or agents is an employee, agent or representative of Medical Group or any Physician. However, in order to avoid embarassment to Medical Group and Physicians which might arise if Health Plan were to exercise its legal rights to advertise and to solicit, and to define the areas in which Health Plan may act freely on its own behalf consistent with Health Plan's desire to avoid actions which might be embarassing to Physicians or Medical Group, it is agreed that:

Section E-1. Health Plan Shall Not Advertise or Solicit Medical Practice

Health Plan shall not advertise the medical practice of Physicians or Medical Group, nor shall Health plan solicit patients on behalf of Physicians or Medical Group.

Section E-2. Providing Information to Members

Health Plan may properly take the initiative in informing Members regarding Health Plan and regarding services and facilities available to Members under their Membership Contracts, with due consideration to professional ethical standards.

Section E-3. Providing Information to Non-Members

Health Plan may provide information regarding Health Plan and Health Plan membership to such individuals or groups, including public or semi-public organizations such as legislative or other governmental committees, as may take the initiative in requesting such information, with due consideration to professional ethical standards.

Section E-4. Statistical Surveys, Etc.

Health Plan may make surveys and take such other actions and conduct such other inquiries as may be necessary to develop statistical information regarding economic

demand for Health Plan coverage in various areas, desires and attitudes of Members regarding services arranged by Health Plan, reasons for termination of memberships, and other matters of information relevant to the proper operation of Health Plan. No publication or distribution of the results of such surveys, except as required for internal uses and purposes of Health Plan, shall be made without prior consultation with Medical Group, and no such distribution or publication shall be effected except with due consideration to professional ethical standards.

Article F

Providing and Maintaining Records

Section F-1. Records of Health Plan Membership

Health Plan shall maintain such records and establish and adhere to such procedures as may be reasonably required to determine the number of Members entitled to Medical Services under this Agreement and to permit Medical Group conveniently to identify Members, and shall furnish such information to Medical Group. Medical Group shall cooperate with Health Plan in connection with such records and procedures in order that necessary determinations regarding eligibility for Medical Services and the amount of compensation payable to Medical Group under this Agreement may be accomplished with maximum efficiency and minimum administrative cost.

Section F-2. Patients' Records in General

Medical Group shall maintain, for each patient receiving Medical Services pursuant to this Agreement, a medical record in such form and detail as is customary among medical doctors maintaining accepted professional standards of medical practice in the Service Area. Health Plan shall make arrangements with Hospitals for maintaining hospital medical records in such form and detail as is customary in the Service Area, and Medical Group shall cooperate with Hospitals in maintaining such records.

Section F-3. Financial and Accounting Records

Health Plan and Medical Group shall maintain complete

financial and accounting records in accordance with good accounting practice sufficient for prompt and proper determination of Health Plan Revenue, Net Health Plan Revenue, and all other matters of a financial or accounting nature required for the proper administration of this Agreement.

Section F-4. Statistical Record

Medical Group and Health Plan shall cooperate in keeping statistical records relating to Medical Services, Hospital Services, Health Plan utilization and other matters required for the proper administration of Health Plan's medical and hospital service program.

ARTICLE G

Termination and Miscellaneous Provisions

Section G-1. Term of Agreement

This Agreement is effective as of July 1, 1959 and shall continue in effect to and including June 30, 1961, except as expressly provided in this Article and in Section C-2, neither party shall have any contractual obligation thereafter by reason of this Agreement. However, the parties expect that they will by mutual agreement continue their contractual relationship.

Section G-2. Termination or Extension of Agreement

Either party may give written notice to the other party at least ninety (90) days prior to June 30, 1961 of such party's desire either to terminate this Agreement or to renegotiate particular provisions hereof. Unless notice is given in such manner, this Agreement shall continue in effect from year to year thereafter, subject, however, to termination or renegotiation at the end of any year on ninety (90) days' written notice from either party to the other.

Section G-3. Continuing Responsibility in Case of Termination

Certain Membership Contracts run for fixed periods and may be terminated only at the end of such periods by a

written notice given a specific time in advance thereof. As a result, in the event that this Agreement is terminated at any time and not succeeded by a medical service agreement between the same parties providing for Medical Services to all Members being served by Medical Group at such date of termination, it is likely that there will be many Members having continuing rights to the benefits of Membership Contracts.

In addition, many Membership Contracts provide certain continuing responsibility in the event Health Plan terminates such contracts. A provision typical of such continuing responsibility provisions is set forth in Section C-2.

The intent of this Medical Service Agreement is that Medical Group shall be obligated to furnish all Medical Services required by Membership Contracts, including such as may be required either under continuing responsibility provisions typified by the provisions set forth in Section C-2, or because the Health Plan is not contractually entitled to terminate a Membership Contract contemporaneously with the termination of this Agreement, or because of a combination of both such circumstances.

Accordingly, it is agreed that in the event this Agreement should be terminated and not succeeded by a medical service agreement between the same parties providing for Medical Services to all Members being served by the Medical Group at the date of termination, then Medical Group shall, if, and to the extent so requested by Health Plan, continue to render Medical Services as required fully to satisfy all Medical Service obligations of Membership Contracts not terminated contemporaneously with the termination of this Agreement and all Medical Service obligations incident to continuing responsibility provisions of Membership Contracts terminated either previous to, contemporaneously with, or subsequent to, the termination of this Agreement.

Health Plan shall continue to collect all Health Plan Revenue which it is entitled to collect under the provisions of applicable Membership Contracts on account of Members continuing to receive or entitled to continue receiving Medical Services which Medical Group is obligated to furnish under Section G-3 after the termination of this Agreement, and Medical Group shall receive compensation as provided in Section H-1 with respect to all such Members.

All other compensation and other provisions of this Agreement shall continue in effect insofar as applicable with respect to all Members receiving or entitled to receive Medical Services pursuant to this Section G-3 after the termination of this Agreement.

In the event that it shall at any time appear probable that this Agreement will be terminated and not succeeded by a medical service agreement between the same parties providing for Medical Services to all Members being served by the Medical Group at the anticipated date of termination, then Medical Group and Health Plan shall cooperate in limiting Medical Group's continuing responsibilities under this Section G-3 insofar as practical under the circumstances.

Section G-4. Effect of Changes in Partnership

The parties intend that this Agreement shall continue in effect, regardless of the withdrawal from Medical Group of individual partners or the addition of new partners or other changes in the organization of Medical Group so long as most Physicians who are partners in Medical Group continue their association with Medical Group as now organized, or as it may be reorganized through the voluntary action of partners therein.

Section G-5. Rights of Third Parties

This Agreement is made for the benefit of Members entitled to receive Medical Services hereunder. However, Health Plan and Medical Group reserve the right to amend this Agreement by mutual agreement or to terminate it in any manner herein provided, without notice to, or consent of, any Member; and nothing herein contained shall operate in any manner whatsoever to increase the rights of any Member or the duties or responsibilities of Health Plan or Medical Group over such rights, duties and responsibilities as may exist in the absence of this Agreement.

Section G-6. Principles of Medical Ethics

Health Plan and Medical Group desire that all medical practice pursuant to this Agreement shall be conducted in accordance with ethical principles as reflected in the "Principles of Medical Ethics of the American Medical Associa-

tion" published in June of 1957. If in the course of administration of this Agreement any questions arise relating to the physician-patient relationship or other matters involving problems falling within the scope of medical ethics, applicable principles of medical ethics may be referred to as a guide in the interpretation of this Agreement.

In the event that action may be initiated by any professional medical association or society predicated on allegations that one or more provisions of this Agreement are unethical, or if the Medical Group experiences serious difficulty in engaging physicians by reason of widely held objections, on ethical grounds, to any provisions of this Agreement, then Health Plan shall use its best efforts to work out with Medical Group mutually satisfactory substitutes therefor sufficient to remove or overcome such professional ethical objections.

Section G-7. Adjustment for Gross Inequities.

The parties to this Agreement recognize the considerations involved in determining the present per Member price specified in Article H, other compensation arrangements, assignment of functions and responsibilities, and other matters covered by this Agreement are complex. Thus, during the term of this Agreement it may develop that, through inadvertence or mistake, or erroneous assumptions, on the part of either party, this Agreement embodies compensation arrangements or other provisions which do not work out in practice as anticipated, or which are grossly inequitable to either party. In such event, Health Plan and Medical Group will endeavor in good faith to work out mutually satisfactory arrangements consistent with their underlying intention that the nonprofit hospital and medical service program maintained by Health Plan shall be conducted, and contractual arrangements between Health Plan and Medical Group shall be established and adjusted to provide:

1. Compensation to Medical Group sufficient to enable Medical Group to provide medical care of good quality in accordance with accepted medical and surgical practices prevailing in the Service Area and compatible with Medical Group's principles.

2. Comprehensive benefits to Members at the most rea-

sonable cost consistent with desirable standards of Medical Services and Hospital Services; and

3. Sufficient revenue to Health Plan to meet all Health Plan operating requirements and to provide for improving and expanding facilities and services in the interest of present and prospective Members.

Part III

FINANCIAL AND ADMINISTRATIVE PROVISIONS

Article H

Base Compensation to Medical Group

As base compensation to Medical Group for Medical Services to be provided by Medical Group hereunder, Health Plan shall pay to Medical Group the amounts specified in this Article H.

Section H-1. Per Member Price

Health Plan shall determine the average number of Members, whether paying, nonpaying, exercising continued coverage rights following termination, or otherwise, entitled to Medical Services to be provided by Medical Group within the Service Area for each month during the term of this Agreement, and shall pay to Medical Group an amount equal to such average membership multiplied by the per Member price in effect for the month. Payments equal to approximately 25% of the estimated amount due for the month will be made on the 7th, 14th, 21st and 28th of each month, with a final payment being made no later than the 20th of the following month. The initial per Member price for July 1959 and each succeeding month, until adjusted pursuant to this Agreement, is the sum of $2.61329 per Member per month.

As of the effective date of this Agreement, determination of the number of Members entitled to Medical Service hereunder is being made monthly. It is understood that existing procedures with regard to determining the number of Members, as well as providing identification to Members,

shall not be changed without consultation between Health Plan and Medical Group.

Section H-2. Adjustments to Per Member Price

The initial per Member price provided under Section H-1 shall be subject to adjustment during the term of this Agreement, as follows:

a. *Escalation for Union-Negotiated Increases.* As of the effective date of any union-negotiated increases in direct wages and salaries and fringe benefits, taking effect after June 30, 1959, affecting personnel employed by Medical Group, the per Member price shall be adjusted so as to provide Medical Group with additional revenue to adjust for such union-negotiated compensation increases.

In computing such adjustment, the provision for compensation to unionized employees of Medical Group included in the initial per Member price established by Section H-1 shall be utilized, and the percentage increase negotiated between union and Medical Group shall be applied to such provision.

b. *Escalation for General Economic Increases to Non-unionized Personnel Other than Physicians.* If, as a consequence of a union-negotiated compensation increase, or otherwise, Medical Group extends a general economic compensation increase or fringe benefits to non-unionized employees other than Physicians, and such increase is approved by Health Plan, the per Member payment shall be adjusted, as of the effective date of such general increase, so as to provide Medical Group with additional revenue to adjust for such increase.

In computing such adjustment, the provision for compensation to non-unionized employees other than Physicians included in the initial per Member price established by Section H-1 shall be utilized, and the percentage increase approved by Health Plan shall be applied to such provision.

Section H-3. Provision for Additional Adjustments.

The initial per Member price specified in Section H-1 as adjusted pursuant to Section H-2 shall continue in effect through June 30, 1960. Effective July 1, 1960, additional adjustments shall be made as follows:

a. *Adjustment for Supply Cost Increases.* Effective July 1, 1960, the per Member per month price in effect under

this Agreement for June 1960 will be further adjusted by an amount equal to the increase in the cost of supplies provided by Medical Group in rendering service under this Agreement as reflected in the latest available projection of supply costs by the Financial Planning Department of Permanente Services, Inc. which adjustment is now estimated to equal approximately $.01700 per Member per month.

b. *General Adjustment for Physicians.* In addition, Health Plan and Medical Group have negotiated an increase in the per Member per month price of $.08940 to take effect July 1, 1960.

Section H-4. Provision for Savings and Retirement Program for Physicians.

In the event that Medical Group establishes a savings and retirement plan or other deferred compensation plan approved by Health Plan, Health Plan will pay, in addition to all other sums payable by Health Plan under this Agreement, the contributions required under such plan to the extent that such contributions exceed amounts, if any, contributed by Physicians; provided, however, that Health Plan shall commence contributions July 1, 1959, and provided further that Health Plan's obligation to make such contributions shall continue only so long as this Agreement or any continuation or extension generally similar to this Agreement shall remain in effect. (The per Member price established by Section H-1 as adjusted pursuant to Section H-2 includes a provision to cover Medical Group's cost on account of Other Personnel under the Kaiser Permanente Retirement Plan which was made effective July 1, 1959.)

Article I

Additional Compensation to Medical Group

In addition to base compensation for Medical Services, as provided in Article H, Health Plan shall pay to Medical Group fifty (50) percent of Net Health Plan Revenue, if any. Such additional compensation shall be determined and paid as provided in this Article I.

Section I-1. Determination of Net Revenue

From Health Plan Revenue, determined in accordance

with sound accounting practice, Health Plan shall pay, reserve for, or otherwise provide for the following:

a. All Health Plan operating costs and expenses, including all amounts required on account of

(i) Insurance and Claims;
(ii) All expenses incurred in connection with adjusting or defending Claims;
(iii) All expenses incurred in connection with programs to reduce losses on account of Claims;
(iv) Out-of-Area Claims;

except such expenses, if any, as may be properly allocable under sound accounting practice to the collection of revenue other than Health Plan Revenue as herein defined;

b. All obligations to Medical Group under Article H;

c. All obligations to Hospitals under Article of the Hospital Service Agreement of January 1, 1959 between Health Plan and Hospitals.

The balance of Health Plan Revenue remaining after all of the foregoing have been paid, reserved, or otherwise provided for, shall, for all purposes of this Agreement, constitute Net Health Plan Revenue.

Section I-2. Retained Net Earnings

From Net Health Plan Revenue developed during any fiscal period used as a basis for determining Net Revenue, Health Plan shall retain net taxable income of One Hundred Dollars (100.00) per month for the period.

Section I-3. Payment of Net Revenue

Health Plan shall estimate its Net Revenue on a quarterly basis, and shall pay to Medical Group its share of Net Revenue for each quarter, as so estimated, within twenty (20) days after the close of the next succeeding calendar quarter, always reserving Net Revenue for one calendar quarter as security against overpayments resulting from adverse changes in operating results within the fiscal period, from audit adjustments and other causes; such payments shall be tentative only and subject to Health Plan's right of recapture by payment or offset in the event audited operating results for the fiscal period reveal that tentative payments based on estimates of Net Revenue were excessive.

Section I-4. Distribution of Additional Compensation Based on Net Revenue

Subject to the provisions of Section I-3, Additional Compensation based on Net Revenue will be paid to Medical Group, free of restriction, for distribution among partners and employees of Medical Group in such manner as Medical Group, in its discretion, may determine. Medical Group intends to work out equitable arrangements under which Additional Compensation paid pursuant to this Article will be distributed, in whole or in part, among partners and employees on an individual, department, subgroup, or other appropriate basis so as to constitute an effective incentive for efforts of individuals, departments and subgroups to further the common interests of Health Plan and Medical Group in providing maximum benefits to Members at the most reasonable cost consistent with maintaining accepted professional standards of Medical Services and Hospital Services.

Article J

Responsibility for Facilities and Administration

Under this Agreement Health Plan is primarily responsible for providing facilities and general administrative services required or convenient in connection with the administration of the nonprofit hospital and medical service program; however, Medical Group controls, and is primarily responsible for the actual operation of outpatient medical offices, and, as a consequence, may most conveniently provide certain administrative services in connection with the nonprofit hospital and medical service program.

This Article outlines major responsibilities of Health Plan and Medical Group with respect to facilities and administration. Medical Group shall carry out its responsibilities relating to facilities and administration as provided by this Article and elsewhere in the Agreement for the consideration specified in Articles H and I, except to the extent that additional consideration is expressly provided.

Section J-1. Collection of Health Plan Revenue

Health Plan shall be primarily responsible for collecting

and receiving all Health Plan Revenue; Health Plan shall directly collect Dues and such Supplemental Charges as it may conveniently collect, and shall have functional responsibility for collection of all Health Plan Revenue.

In certain situations and at certain locations some categories of Health Plan Revenue may, in the first instance, be more conveniently collected by Medical Group. In such situations, Medical Group shall, to the extent requested by Health Plan, collect Health Plan Revenue for the account of Health Plan in accordance with the policies and procedures established by Health Plan; however, Medical Group shall retain administrative responsibility over all Medical Group personnel engaged in the collection of Health Plan Revenue. In consideration of the services rendered by Medical Group in the collection of Health Plan Revenue, and in addition to all other payments to Medical Group provided for by this Agreement, Health Plan shall pay to Medical Group a reasonable allowance to cover costs actually incurred by Medical Group in so collecting Health Plan Revenue. Said allowance shall be established by mutual agreement or by fair and realistic allocation of Medical Group costs in accordance with sound accounting principles.

Section J-2. Providing Medical Facilities and Equipment

Health Plan is responsible for providing satisfactory medical facilities together with Built-in Equipment and Movable Equipment reasonably required by Medical Group in furnishing Medical Services pursuant to this Agreement; provided, however, that Health Plan reserves the right of final decision as to additional facilities and expansion of existing facilities provided by it. Health Plan may carry out this responsibility by purchasing, contracting for, leasing or constructing appropriate facilities; regardless of how such facilities are acquired by Health Plan, all such facilities requested by Medical Group, excepting hospital facilities, shall be leased to Medical Group on mutually agreeable terms which will insure that, for the duration of each such lease, Medical Group shall have exclusive control of such facilities and of all medical practice conducted therein.

Health Plan's responsibility to provide facilities reasonably required for the rendition of Medical Services hereunder is not intended to limit Medical Group in any

way in purchasing, constructing, leasing or otherwise acquiring such equipment and facilities as it may desire, but costs or rental charges incurred on expenditures or investments made by Medical Group in so acquiring facilities or equipment shall not be taken into account in any fashion in determining payments to Medical Group under this Agreement unless such equipment and facility acquisitions have the prior written approval of Health Plan.

Article K

Claims Adjustment and Settlement

As a consequence of Health Plan's nonprofit hospital and medical service program, a variety of Claims, as defined in Section A-6, arise against Health Plan or Medical Group or Hospitals, or against any two or all of said contracting organizations. The difficulties, expenses and disadvantages of determining and allocating final responsibility for many such Claims, and the advantages of handling all such Claims on a cooperative basis, are such that it appears to be to the mutual advantage of the parties to this Agreement and of Hospitals to handle all such Claims in the manner provided in this Article.

Section K-1. Insurance

Medical Group shall maintain insurance in amounts and with carriers satisfactory to Health Plan covering Liability Claims and liability aspects of Mixed Claims.

Unless otherwise agreed between Health Plan and Medical Group, it is understood that for the period of this Agreement insurance with limits of $600,000 on account of liability to any one person arising out of any occurrence, and $3,000,000 on account of aggregate liability to all claimants during an insurance policy year shall be deemed sufficient. There may be excluded from the protection afforded by such insurance the first $25,000 of liability on account of any occurrence. Different liability limits may be approved by Health Plan with respect to particular classes of risks.

Section K-2. Payment of Premiums

Health Plan shall pay, as Health Plan expenses, all premiums applicable to insurance carried by Medical Group

pursuant to the requirements of the foregoing paragraph. In this connection it is understood that Health Plan's responsibilities relating to Claims arising out of acts or omissions of Medical Group, Physicians, Other Personnel and agents or other representatives is limited to payment of premiums on such insurance as Medical Group, acting with the approval of Health Plan, shall place, and that Health Plan has no responsibility to see that such insurance is either placed or maintained in effect.

Section K-3. Adjustment, Defense and Settlement of Claims

Health Plan shall make arrangements for adjusting, defending, settling and paying Claims, and shall incur, as Health Plan expenses, all costs incurred in connection therewith, including the cost of discharging liability established by settlement or judgment within the scope of the $25,000 uninsured liability permitted by the provisions of Section K-1. Health Plan shall have no responsibility by reason of this Agreement for paying liability established by settlement or judgment in excess of $25,000 on account of any single occurrence.

In carrying out its responsibilities in connection with adjusting, defending, settling and paying Claims, Health Plan shall maintain liaison with Medical Group, and Health Plan shall not cause any Claim asserted against Medical Group to be settled or paid without the approval of Medical Group.

Section K-4. Loss Prevention Program

Health Plan shall bear, as Health Plan expenses, all costs incurred in connection with a loss prevention program to be conducted under the general supervision of Medical Group for the purpose of reducing losses to Hospitals, Health Plan and Medical Group on account of claims. Said loss prevention program shall be conducted on a cooperative basis as a joint effort of Hospitals, Health Plan and Medical Group, acting with such assistance from attorneys experienced in liability matters and other qualified personnel as may appear most advantageous to the efficient and economical conduct of the loss prevention program.

Health Plan's responsibility for bearing the costs of such

program shall not include compensation to Hospital or Medical Group personnel devoting time to such program.

Section K-5. Fundamental Responsibility for Claims

Although for the mutual convenience of the parties to this Agreement and Hospitals, Health Plan is undertaking to pay insurance premiums and certain other specified costs in connection with Claims, it is recognized that fundamental responsibility for most Liability Claims and many other Clams rests with Medical Group and Hospitals as providers of services. It is not the intention of this Agreement to shift such ultimate responsibility; instead, this Agreement is intended simply to provide convenient and mutually advantageous arrangements for disposing of Claims, without regard to ultimate responsibility therefor, within the limitations herein specified.

Health Plan will discharge its obligations in connection with payment of premiums and disposition of Claims on a current basis, because Health Plan has no reserves nor satisfactory means of accumulating reserves for meeting obligations in connection with Claims. Accordingly, it is understood that Health Plan's obligations under this Article K shall continue only so long as this Agreement, or any renewal or extension hereof, is in effect between the parties hereto.

Incident to the establishment of arrangements as provided in this Article for handling of Claims on a current basis, Health Plan shall be entitled to receive such refunds, if any, as may be applicable to liability insurance covering Medical Services and Hospital Services to Health Plan Members in prior years, and related risks; and Health Plan shall be responsible for such premium adjustments and legal expense, if any, as may be required by reason of insurance in effect and claims incurred with respect to such prior years. Except as provided in the preceding sentence, Health Plan's obligations under this Article shall be limited as follows:

a. Health Plan's obligation to pay insurance premiums shall apply only to premiums applicable on a pro-rata basis to the period of this Agreement.

b. Health Plan's obligations to arrange for and pay for defense, adjustment and settlement of Claims shall cover

only such expenses as are incurred for services rendered during the period of this Agreement.

c. Health Plan's obligation to satisfy liability established by judgment or settlement shall extend only to settlements agreed upon, and liabilities established by judgments becoming final, during the term of this Agreement.

Any expense or obligation connected with Claims not specifically assumed by Health Plan under this Article K, including liability in excess of insurance policy limits, liability not covered by insurance (excepting liability within the scope of the $25,000 deductible portion of insurance in effect) and Claims adjustment, defense and settlement expense, and costs of discharging liability established by judgment or settlement after termination of this Agreement, shall be for the sole account of Medical Group, Hospitals or Health Plan in accordance with their ultimate responsibilities, unaffected by this agreement.

Section K-6. Claims Against Health Plan Only

Health Plan shall have sole responsibility for adjusting, settling or defending all Claims not involving any alleged act or omission on the part of Medical Group or Hospitals, including Out-of-Area Claims. To the extent that such Claims involve problems of medical judgment relating to the emergency nature of Medical Services and similar matters, Medical Group shall, if so requested by Health Plan, consult with and advise Health Plan.

Section K-7. Malpractice Reserve.

As protection to Medical Group and Health Plan against liability, uninsured under the $25,000 deductible provision referred to in Section K-1, in the event that this Agreement or any renewal or extension hereof shall in the future not be in effect between the parties hereto, Health Plan shall reserve such sum, if any, as may be mutually agreed upon between Health Plan and Medical Group, which reserve shall be held by Health Plan under a trust, agreement or other mutually satisfactory arrangement providing, in substance:

a. That the value represented by such reserve shall not be utilized or distributed for any purpose except payment of liability established by settlement or judgment after termination of this Agreement and all extensions or re-

newals hereof, and adjustment and defense costs incurred after such termination, on account of claims or suits alleging liability for personal injury against Medical Group or Physicians or Other Personnel of Medical Group, either alone or in conjunction with other defendants, which liability is uninsured by reason of the $25,000 deductible provision referred to above.

b. That the reserve may be invested in assets required in connection with Health Plan operations, provided that the value is soundly maintained.

c. That after termination of this Agreement and all succeeding continuations or renewals hereof, amounts so reserved in excess of amounts reasonably required under sound and conservative standards to provide fully for all potential outstanding liability and related defense and adjustment expense to which such reserve could properly be applied, may be applied and utilized by Health Plan in furtherance of Health Plan purposes or paid to Kaiser Foundation Hospitals or such other corporation or foundation organized and operated for public hospital charitable, research, educational or similar purposes, as the Board of Directors of Health Plan may designate, or distributed in such other manner as may be mutually agreed between Medical Group and Health Plan.

Part IV.

PROVISIONS RELATING TO LIAISON AND COOPERATION

Article L

Exchange of Information and Cooperation Regarding Policies

In order to achieve orderly and effective administration of this Agreement and of Membership Contracts covering Health Plan Members within the Service Area, a full exchange of information between Health Plan and Medical Group and full cooperation regarding policies and major decisions of Health Plan and Medical Group in all matters affecting Health Plan's nonprofit hospital and medical service program, arrangements for Medical and Hospital Services, and necessary facilities is essential. The follow-

ing arrangements are made in furtherance of these purposes:

Section L-1. Inspection of Records, Facilities, Etc.

Both Health Plan and Medical Group shall have the right to inspect accounting and administrative books and records maintained, and facilities owned or operated by, the other party at all reasonable times.

Section L-2. Medical Records

Health Plan shall arrange for medical records of Members, maintained by Hospitals, to be available to Medical Group; medical records of Members maintained by Medical Group shall be available to Health Plan for inspection and use in connection with all matters relating to Claims, and with respect to other matters arising in connection with the administration of Membership Contracts to the fullest extent consistent with maintaining the confidences of patients as required by the physician-patient relationship and the Principles of Medical Ethics of the American Medical Association.

Section L-3. Other Information

In addition to the foregoing particular matters, Medical Group and Health Plan shall maintain a free exchange of information regarding all other matters relating to or connected with the administration of this Agreement and of Membership Contracts covering Members in the Service Area.

Section L-4. Changes in Facilities

No substantial changes in or additions to facilities for serving Health Plan Members in the Service Area shall be made until after proposed changes or additions have been discussed and considered jointly by Health Plan and Medical Group.

Section L-5. Rates

The parties desire to provide Medical Group with maximum freedom to carry out its responsibilities to provide Medical Services in accordance with the professional standards and judgment of Medical Group and without inter-

ference by Health Plan in the establishment and control of standards of medical care, but with due respect for basic economic limitations under which any medical and hospital service program must operate. Accordingly, it is understood and agreed that, prior to effecting any changes in the schedule of prepaid Dues and Supplemental Charges, Health Plan will consult with Medical Group regarding additional services and additional medical care requirements suggested or proposed by Medical Group, and will consider the costs thereof, in conjunction with all other factors affecting Health Plan rates, to the end that funds for additional medical services and medical care requirements shall, to the fullest extent practical, be provided in a manner which does not require specific Health Plan approval for any such additional service or additional requirement.

Section L-6. Interpretation of Contracts.

Policy questions relating to the interpretation of Membership Contracts shall be subject to joint discussion and consideration by Health Plan and Medical Group, with final authority on questions of interpretation being distributed as follows:

a. *Medical Questions.* All questions relating to interpretation of Membership Contracts primarily involving questions of a medical nature or relating primarily to physician-patient relationships or to the professional and ethical responsibilities of physicians shall be resolved by Medical Group after joint discussion with Health Plan.

b. *Other Matters.* All matters of interpretation arising under Membership Contracts which do not involve primarily questions of a medical nature or relating primarily to physician-patient relationships, or to the professional ethical responsibilities of physicians shall be finally resolved by Health Plan after joint discussion with Medical Group. This classification includes questions relating to membership relations and moral responsibility as well as questions of legal responsibility.

Executed July 15, 1959, at Oakland, California, to take effect as of July 1, 1959.

THE PERMANENTE MEDICAL GROUP,
A Limited Partnership

By C. C. Cutting, M.D.
C. C. CUTTING, M.D.
General Partner

KAISER FOUNDATION HEALTH PLAN, INC.
A California Nonprofit Corporation.

By Fred W. Tennant
FRED W. TENNANT
Regional Manager

KAISER FOUNDATION HEALTH PLAN, INC.
OAKLAND, CALIFORNIA PHONE OLYMPIC 4-2090

The Permanente Medical Group
368 42nd Street
Oakland 9, California

Attention: C. C. Cutting, Executive Director

Gentlemen:

This Letter of Understanding supplements our Medical Service Agreement for the Period July 1, 1959 through June 30, 1961, and shall continue subject to such amendments as may be mutually agreed upon, so long as said Medical Service Agreement, or any renewal or extension thereof, shall remain in effect.

1. *Effect of Certain Membership Contract Exclusions*

Pursuant to Section A-3-d-3, it is understood that to the extent the relevant exclusions in membership contracts are, in fact, applied, professional services for Health Plan Members treated for the conditions hereafter enumerated shall be deemed Private and Industrial Medical Services:

a) Waived conditions
b) Psychiatric care
c) Tuberculosis, after Diagnosis *
d) Fertility Studies
e) Cosmetic Surgery
f) Dental X-Rays (when not covered under Health Plan contracts)
g) Services for Patients hospitalized for Dental Surgery
h) Conditions resulting from Attempts at Suicide
i) Intentionally Self-Inflected Injuries or Illnesses, or complications resulting therefrom
j) Alcoholism

* (Refer to Health Plan Office for Members in Groups 4, 6, 14, 24, 33, 83, 101, 124, 183, 222, 293, 364, 399 and 710)

k) Conditions for which the Member is entitled to receive care from the Veterans Administration

l) The following contagious diseases (except that diagnostic services for such diseases are not included):

Amebiasis, including dysentery
Anthrax
Chicken pox (varicella)
Cholera
Choreomeningitis, lymphocytic
Coccidiomycosis
Diarrhea, infectious, of infants
Diphtheria
Dysentery, bacterial
Encephalitis, infectious
Glanders
Leprosy
Measles (rubeola)
Measles (German (rubella))
Meningococcal infections (including epidemic meningitis)
Mumps
Pertussis (whooping cough)
Plague
Poliomyelitis, acute
Rabies
Salmonella infections (including paratyphoid)
Scarlet Fever
Small pox (variola)
Trachoma
Tuberculosis
Typhoid Fever
Vulvovaginitis in children
Yellow Fever

2. *Medical Group Direct Revenue*

Supplementing Section A-4-a-6, it is understood that the following categories of revenue are excluded from the definition of Health Plan Revenue and shall constitute Medical Group direct revenue:

a) Sales by Medical Group of medical supplies, such as ace bandages, and including manufactured

materials sold to other than Health Plan Members, or not included in Membership coverage.

b) Amounts received by Medical Group as witness fees or on account of completing claim forms, or inductrial medical, or other medical reports.

3. *Policy on Literature and Publicity*

As a matter of operating policy, Health Plan shall consult with, and obtain the approval of Medical Group before distributing literature or other material or presenting or releasing other publicity (radio and television broadcasts) pursuant to Sections E-2, E-3 and E-4, where such literature material or publicity relates to the rendering of professional medical services.

4. *Operation of Optical Departments*

Supplementing Section J-1, it is understood that in connection with the operation of Optical Departments, Medical Group shall collect Optical Department revenue for Health Plan's account, and Health Plan shall reimburse Medical Group for all costs or expenses paid or incurred by Medical Group directly connected with operating Optical Departments and collecting Optical Department revenue except for costs and expenses incident to furnishing of professional services in the prescribing of lenses, which latter expenses Medical Group shall bear.

5. *Leasing of Facilities*

Supplementing Section J-2, it is understood that all costs and expenses incurred by Health Plan in connection with the acquisition and leasing of facilities constitute Health Plan operating expenses, provided, however, that the recovery of capital costs at a rate faster than that provided by normal depreciation and over a period of less than fifteen years shall require the prior approval of Medical Group.

6. *Malpractice Reserve*

Supplementing Section K-7, it is understood that Health Plan will endeavor, in cooperating with Medi-

cal Group, to work out a mutually satisfactory basis for handling the problem of malpractice reserves to take effect commencing not later than July, 1961, the expected date of renewal or extension of the Medical Service Agreement.

It is, of course, understood that the Medical Service Agreement effective July 1, 1959, to which this letter is an addendum, is a continuation of the main provisions of the preceding Medical Service Agreement effective April 1, 1958 through June 30, 1959. It is further understood that the provisions of Section H-3 were negotiated for purposes of this Agreement only and do not necessarily constitute a precedent for similar compensation adjustments in future Medical Service Agreements or renewals or extensions of this Medical Service Agreement.

KAISER FOUNDATION HEALTH PLAN, INC.

By Fred W. Tennant
Northern California Regional Manager

The foregoing Letter of Understanding is accepted and agreed to this 25 day of July, 1959.

THE PERMANENTE MEDICAL GROUP

By C. C. Cutting
C. C. CUTTING
Executive Director

AMENDMENT TO MEDICAL SERVICE AGREEMENT

Northern California Region

Kaiser Foundation Health Plan, Inc., a California nonprofit corporation, and The Permanente Medical Group, a limited partnership, hereby adopt the following amendments to the Medical Service Agreement between them covering the period from July 1, 1959 through June 30, 1961, as amended to cover the period July 1, 1961 through June 30, 1962:

Equal Employment Opportunity

Health Plan has executed a contract with the United States Civil Service Commission which, pursuant to Executive Order No. 10925, requires Health Plan to insert the following provisions concerning Equal Employment Opportunity in all contracts which it executes with subcontractors in which a material part of the services covered will be rendered in the performance of the Health Plan's contract with the Civil Service Commission.

Section 1. Nondiscrimination Provision.

Medical Group will not discriminate against any employee or applicant for employment because of race, creed, color, or national origin . Medical Group will take affirmative action to ensure that applicants are employed, and that employees are treated during employment, without regard to their race, creed, color, or national origin. Such action shall include, but not be limited to, the following: employment, upgrading, demotion or transfer; recruitment or recruitment advertising; layoff or termination; rates of pay or other forms of compensation; and selection for training, including apprenticeship. Medical Group agrees to post in conspicuous places, available to employees and applicants for employment, notices to be provided by the contracting officer setting forth the provisions of this nondiscrimination clause.

Section 2. Solicitation or Advertisement for Employees.

Medical Group will, in all solicitations or advertisements

for employees placed by or on behalf of Medical Group, state that all qualified applicants will receive consideration for employment without regard to race, creed, color, or national origin.

Section 3. Notice to Labor Unions.

Medical Group will send to each labor union or representative of workers with which it has a collective bargaining agreement or other contract or understanding, a notice, to be provided by the agency contracting officer, advising the said labor union or workers' representative of Medical Group's commitments under this section, and shall post copies of the notice in conspicuous places available to employees and applicants for employment.

Section 4. Compliance with Executive Order No. 10925 and Rules and Regulations.

Medical Group will comply with all provisions of Executive Order No. 10925 of March 6, 1961, and of the rules, regulations, and relevant orders of the President's Committee on Equal Employment Opportunity created thereby.

Section 5. Furnishing Information and Reports.

Medical Group will furnish all information and reports required by Executive Order No. 10925 of March 6, 1961, and by the rules, regulations, and orders of the said Committee, or pursuant thereto, and will permit access to its books, records, and accounts by the contracting agency and the Committee for purposes of investigation to ascertain compliance with such rules, regulations and orders.

Section 6. Termination for Non-compliance.

In the event of Medical Group's non-compliance with the nondiscrimination clauses of this Agreement or with any of the said rules, regulations, or orders, this Agreement may be cancelled in whole or in part and Medical Group may be declared ineligible for further government contracts in accordance with procedures authorized in Executive Order No. 10925 of March 6, 1961, and such other sanctions may be imposed and remedies invoked as provided in the said Executive Order or by rule, regulation, or order of

the President's Committee on Equal Employment Opportunity, or as otherwise provided by law.

Executed March 19, 1962 at Oakland, California, to take effect as of March 19, 1962.

THE PERMANENTE MEDICAL GROUP,
A limited partnership

By C. C. Cutting, M.D.
General Partner

KAISER FOUNDATION HEALTH PLAN, INC.
A California nonprofit corporation

By Fred W. Tennant
Regional Manager

TRUST AGREEMENT

Retirement Plan for The Permanente Medical Group

EXHIBIT C

Trust Agreement

Retirement Plan for The Permanente Medical Group

This Trust Agreement among Kaiser Foundation Health Plan, Inc., a California nonprofit corporation, (hereinafter called "Health Plan"), The Permanente Medical Group, a limited partnership of physicians, (hereinafter called "Medical Group"), and Bank of America National Trust and Savings Association, (hereinafter called "Trustee"), has been entered into effective as of the 1st day of July, 1959, by reason of the following circumstances:

I. Health Plan and Medical Group desire to establish a plan to provide retirement incomes and other benefits for physicians associated with Medical Group who qualify under the standards provided in this Trust Agreement, subject to the conditions and limitations hereinafter set forth, and desire to establish a Trust to assist in carrying out such plan. Trustee is willing to accept such Trust in accordance with the terms of this Trust Agreement.

II. The parties recognize that many presently unforeseen factors may make it necessary or desirable to extend the coverage of this Agreement to other physicians or other medical groups or otherwise modify this Agreement, and desire to maintain maximum flexibility to the end that the basic purposes of this Trust Agreement, namely, establishing a means for providing retirement incomes and other benefits to physicians cooperating with Health Plan in providing medical services to Health Plan members, may be achieved in the most efficient, practical and economical manner.

By reason of the foregoing circumstances and for the purpose of carrying out the purposes just described, the parties hereby agree as follows:

Article A.

Definitions

As used in this Trust Agreement the terms set forth in this Article shall have the meanings set forth herein, except

where from the context it is clear that such meanings are not intended.

Section A-1. Parties to or Affected by Agreement.

a. "Medical Group" shall mean The Permanente Medical Group, a limited partnership whose original Certificate of Partnership was filed with the County Clerk of Alameda County, California, June 29, 1949 in Book 5963 on page 595, and shall include the group of physicians who are partners in or otherwise associated with The DeKruif, Eckhardt, Mott, Rubin, Stricker Medical Group, a general partnership of physicians practicing medicine in San Leandro, California, and vicinity, as such medical groups now exist and as they may be changed from time to time by the addition of new personnel, by retirement, by reorganization, or otherwise.

b. "Health Plan" shall mean the Northern California Region, a separate division of Kaiser Foundation Health Plan, Inc., a California nonprofit corporation.

c. "Member" shall mean any person regularly entitled to medical services from Medical Group pursuant to a service contract issued by Health Plan.

d. "Participant" shall mean a physician who meets the requirements established by Section D-2, for participation in the benefits contemplated by this Trust Agreement, and elects so to participate.

e. "Trustee" shall mean Bank of America National Trust and Savings Association and any successor thereto appointed pursuant to Section K-1 hereof.

f. "Insurer" shall mean the insurance company selected to write the group annuity deposit administration contract contemplated by this Trust Agreement, and in the event that the insurance company initially selected, or any insurance company subsequently selected, shall for any reason be replaced, said term shall apply to successor insurance companies.

g. "Affiliated Medical Group" shall mean any partnership, or other organization of physicians which provides professional medical services pursuant to a contract with Health Plan or with any other corporation or organization conducting the Kaiser Foundation Health Plan medical and hospital service program in any geographical area, and

which is not the Medical Group under this Trust Agreement.

Section A-2. Other Definitions.

a. "Continuous Full-time Association" shall mean association with Medical Group as an employee or partner devoting substantially full time, in accordance with the standards from time to time established by Medical Group, to the rendition of medical and necessary administrative services in connection with Medical Group's medical practice; provided, however, that after such association has been established, leaves of absence granted by Medical Group for or on account of any of the following purposes:

i. Military service;

ii. Medical research;

iii. Advance study in the field of medicine;

iv. Temporary disability;

v. Any other purpose which Medical Group shall authorize and which the Retirement committee shall approve;

shall not be deducted in determining the extent of Continuous Full-time Association for any purpose under this Trust Agreement.

In accordance with Article H, association with an Affiliated Medical Group may also be considered Continuous Full-time Association under this Trust Agreement. Notwithstanding the preceding provisions of this definition, Continuous Full-time Association prior to the effective date of this Trust Agreement by any Participant who became a Participant under the Trust Agreement on said effective date shall be the number of years shown after the Participant's name in Schedule 1 of Appendix A to this Trust Agreement.

b. "Fiscal Year" shall mean the twelve months period from July 1st through June 30th, inclusive.

c. "Retirement Committee" shall mean the committee provided for in Section J-1.

d. "Medical Subcommittee of Retirement Committee" shall mean that committee provided for in Section J-2.

Article B.

Contributions

Section B-1. Initial Contribution.

Health Plan hereby contributes to this Trust as an initial deposit hereunder, and Trustee acknowledges receipt of, the sum of Two Hundred Thousand Dollars ($200,000.00) representing a portion of the amount agreed to be paid by Health Plan for physician retirement income and other benefits during 1959.

Section B-2. Further Contributions.

It is contemplated that Health Plan will continue, indefinitely contract with Medical Group for medical services to Health Plan Members in the San Francisco Bay Area and vicinity; and it is further contemplated that, so long as such contractual relations between Health Plan and Medical Group continue, Health Plan will contribute a certain sum per Member per month to this Trust, to be held, applied and distributed in accordance with the provisions of this Trust Agreement. However, it is distinctly understood that Health Plan's obligation to make contributions to this Trust depends entirely upon, and is governed by, medical service agreements between Health Plan and Medical Group, and this Trust Agreement does not obligate Health Plan to make any future contributions to this Trust. Effective July 1, 1959 and continuing thereafter until changed by future medical service agreements between Health Plan and Medical Group, the rate of Health Plan's contribution to this Trust shall be twelve (12) cents per member per month. The basis for determining membership for the purpose of such contributions, and the time of payment thereof, shall be the same as that in effect from time to time for compensating Medical Group for providing medical services to Health Plan Members.

Section B-3. Payment to Insurer.

Trustee shall receive all amounts contributed to this Trust, and, after deducting such amounts as Trustee is authorized to retain under Section K-3 of this Trust Agreement, shall promptly pay over the balance, or, if so directed

by the Retirement Committee, a part of such balance to the Insurer under the master contract or contracts to be entered into pursuant to Section C-1, as initially established, or as changed from time to time pursuant to this Trust Agreement. Any part of such balance that the Trustee is not directed to pay to the Insurer shall be invested by the Trustee in accordance with the provisions of Section K-2 of this Trust Agreement.

Article C.

Deposit Administration

Section C-1. Master Contract.

In order to provide the retirement income benefits contemplated by this Trust Agreement, Trustee shall enter into a deposit administration contract, satisfactory to the Retirement Committee, with an insurance company satisfactory to the Retirement Committee, authorized to do business in the State of California.

In addition to such guaranties and other provisions as may be negotiated relating to interest, insurance rates, benefits and other matters, the master contract shall require that the Insurer shall properly keep such records and accounts as may be reasonably necessary for the administration of this Trust Agreement and the master contract.

Section C-2. Insurer to Rely on and Follow Directions of Trustee.

In all actions which it takes in connection with the administration of the master contract and this Trust Agreement, the Insurer shall follow the directions of the Trustee and shall not be required to deal with any other party hereto or Participant or other beneficiary hereunder, except to the extent that it may be so directed by Trustee.

Insurer shall not be responsible for the validity or interpretation of this Trust, and shall not be required to look to the terms hereof, or to see that any action or direction of the Trustee is authorized or permitted hereby, or otherwise to question any such action.

Insurer shall be fully protected in taking or permitting any action in connection with the master contract or this Trust Agreement in reliance on a written instrument ex-

ecuted by the Trustee acting as such, and shall incur no liability for so doing.

However, nothing in this Section shall relieve Insurer of responsibility for any error or omission in carrying out its own functions and responsibilities under the master contract on the basis of information or directions furnished by the Trustee.

Section C-3. Termination of Master Contract.

Any master contract entered into by Trustee pursuant to this Trust Agreement shall permit Trustee, acting pursuant to the advice or written approval of the Retirement Committee, to amend, terminate or replace the master contract at any time, or to withdraw funds deposited pursuant to the master contract and apply such funds for the purposes contemplated by this Trust Agreement in such manner as may appear best suited to providing maximum benefits with the contributions made hereunder and otherwise carrying out the purposes hereof; provided, however, that no amendment or termination of any master contract and no withdrawal or application of funds permitted by this Section shall operate to accelerate the rights of Participants to receive or direct or otherwise control the application of funds being administered hereunder, except upon the written approval of Health Plan or its successor or successors in interest, Medical Group, or its successor or successors in interest, all members of the Retirement Committee, and seventy-five percent (75%) in number of all Participants.

Article D.

Eligibility to Participate

Section D-1. Medical Group Eligibility.

Medical Group shall, upon execution of this Trust Agreement, be eligible to participate hereunder.

Section D-2. Eligibility of Individual Physicians.

Each physician who has completed two years of Continuous Full-time Association with Medical Group on July 1, 1959 shall be eligible to participate as of July 1, 1959.

Any other physician who completes two years of Continuous Full-time Association with Medical Group, as determined in accordance with the rules established by Medical Group, shall be eligible to participate as of the July 1st coinciding with or next following completion of such association, and transferring physicians shall become eligible in accordance with subsection E-1.d. When eligible, a physician may become a Participant by executing an election to participate in the manner and form prescribed by the Trustee; such election shall be executed and delivered to Health Plan for transmission to the Trustee not later than thirty (30) days following the date of eligibility.

Section D-3. Certificates of Eligibility.

By September 15 of each year Medical Group shall deliver to Health Plan for transmission to Trustee a certified report containing such information with respect to all Participants as the Trustee or Insurer may require in the administration of this Trust or of the deposit administration contract or contracts contemplated by Article C hereof. Such required information is expected to include, but is not necessarily limited to, names, dates of birth, extent of Continuous Full-time Association, extent of any leaves of absence permitted hereunder without breaking Continuous Full-time Association, and rates of base salary, base drawing accounts, or other elements of compensation required by the allocation formula developed pursuant to Article E of this Trust Agreement.

Article E.

Allocation to Group and Individual Accounts

Section E-1. Group Accounts.

The Insurer shall maintain an account for Medical Group and shall allocate all contributions made hereunder, and all interest, increments resulting from forfeitures, dividends and other earnings, to the Medical Group account. Said account constitutes only a convenience in the administration of this Trust, and shall establish no right, on behalf of Medical Group or any Participant in the assets represented by said account.

Section E-2. Tentative Individual Accounts—Unit Allocation Formula.

Within the Medical Group account Insurer shall maintain a tentative individual account for each Participant in the Medical Group, and shall make allocations to such tentative accounts in accordance with an allocation formula to be approved by Health Plan, Medical Group and Trustee and set forth as Appendix A to this Trust Agreement. Said allocation formula shall provide for the tentative allocation to the account of each individual Participant of a portion of funds available for allocation, based upon the compensation level, length of service and age of each Participant, as compared with similar factors applicable to all other Participants in the Medical Group. The formula will provide for assignment of units to each physician each Fiscal Year, and promptly upon receipt of the certificates required by Section D-3, the Insurer shall compute the total number of units for Medical Group and the number of units allocable to each Participant within Medical Group.

Section E-3. Determination of Unit Values—Allocation.

As promptly as practical following the close of each Fiscal Year the Insurer shall determine a unit value for Medical Group as follows:

The total of the following amounts shall be determined for the Fiscal Year:

a. Contributions received during such year and interest earned thereon;
b. All increments of value resulting from forfeitures occurring during such year by reason of;
    i. Termination, for any reason other than transfer in accordance with Article E, of the services of any Participant, prior to the date of eligibility for retirement or accelerated retirement in accordance with the standards established by Article F hereof;
    ii. Failure of a Participant eligible for such retirement or accelerated retirement, or of a retired Participant, to observe and comply with the conditions for continued eligibility for benefits;
c. All dividends earned under the master contract and

all other earnings or increments of value, from whatever source, not covered by the foregoing subsections of this Section E-3 or by Section E-5.

The Insurer shall then divide the total so determined by the total number of units for the Fiscal Year within Medical Group, and shall allocate to the tentative individual account of each Participant the amount determined by multiplying such value per unit by the number of units allocated to such Participant.

Section E-4. Units for Partial Year.

If, owing to retirement during a Fiscal Year, leave of absence permitted by Section A-2 without break of Continuous Full-time Association, transfer or other circumstance approved by the Retirement Committee, a Participant devotes less than substantially full time to the rendition of medical or necessary administrative services in connection with Medical Group's practice during any Fiscal Year, the number of units otherwise allocable to such Participant shall be correspondingly reduced for the purpose of all computations and allocations pursuant to Section E-2 and Section E-3.

Section E-5. Interest on Tentative Accounts.

All interest earned under a deposit administration contract applicable to funds tentatively allocated to individual accounts and all other earnings, if any, derived from the investment of such funds other than under a deposit administration contract shall be allocated to such tentative individual accounts at least annually.

Section E-6. Tentative Accounts Establish No Rights.

The tentative accounts and suspended tentative accounts provided for Participants hereunder are solely for the purpose of facilitating record keeping and necessary computations, and confer no rights in the trust fund upon the individuals for whom they are established. Rights to any part of the trust fund or to any benefits under this Trust Agreement, shall exist only at the time, in the manner, to the extent and subject to the limitations and conditions set forth in Article F relating to eligibility for benefits.

Section E-7. Trustee to Establish Accounts.

In the event that the Trustee is requested to hold and invest assets hereunder by the Retirement Committee, the Trustee shall establish and administer both Medical Group and tentative individual accounts in a manner acceptable to both the Retirement Committee and the Trustee, which shall be generally similar to that set forth for the Insurer in the preceding provisions of this Article E.

ARTICLE F.

Eligibility for Benefits

Section F-1. Qualification for Retirement Benefits.

To qualify for a retirement benefit pursuant to this Trust Agreement a Participant must commence Continuous Full-time Association prior to the July 2nd next following his 60th birthday and must either:

a. Complete at least fifteen (15) years of Continuous Full-time Association, or

b. Complete at least ten (10) years of Continuous Full-time Association and attain the age of sixty-five (65) years.

Section F-2. Retirement.

Commencing as of the month next following the effective date of his retirement, and continuing so long as he shall continue to meet the requirements of Section F-4 for continuing retirement benefits, a Participant shall be entitled to receive that monthly retirement income determined as follows:

a. The amount credited to his tentative account or accounts as of June 30 of the year preceding his retirement (or, in the case of any particular account, as of such later date as may be determined by the Retirement Committee) shall be applied to the purchase of a retirement income contract under the primary settlement option provided by the applicable master contract; or, if any election in the form prescribed by the Insurer is made, such amount shall be similarly applied toward the purchase of the optional settlement so elected.

b. As soon as practical after the end of the Fiscal Year during which the Participant retires, the primary or op-

tional retirement income contract selected pursuant to subsection F-2.a. shall be augmented by application of such additional credit to the Participant's tentative individual account or accounts as may result from the Participant's additional allocation for the Fiscal Year during which his retirement occurs.

Section F-3. Deferred Retirement Income.

A Participant may also elect to defer commencing receipt of retirement income for such time as he may desire, but in no event shall retirement income be deferred beyond the beginning of the Fiscal Year next following the Participant's seventieth birthday. If the Participant elects to defer receipt of his retirement income, his retirement income shall be the actuarial equivalent, at the time so elected, of the retirement income to which he would be entitled under Section F-2, [adjusted for additional interest earnings, if any, attributable to the Participant's tentative individual account.]

Section F-4. Requirements for Continuing Retirement Income.

Retirement income payments being made to any retired Participant pursuant to any of the foregoing sections of this Article or pursuant to Section G-1 shall be discontinued, and such retired Participant shall have no further eligibility for, nor right to receive, retirement income pursuant to this Trust Agreement, when, as, and if, any of the following disqualifying circumstances shall occur:

a. If the retired Participant shall, without the prior written consent of Health Plan, render professional medical services on behalf of any other hospital and medical service plan operated on a group practice prepayment basis within any county, in California, Oregon, Washington, or Hawaii, any part of which is within the service area of Health Plan, or within any service area of Kaiser Foundation Health Plan, Inc., a California nonprofit corporation, or the successors of either of them;

b. If, while being physically fit, and legally entitled, to practice medicine, and while being present within any Health Plan service area he shall fail or refuse to render consulting services when reasonably so requested by any

medical group practicing in said area and contracting with Health Plan for the rendition of medical services. Retired Participants shall be entitled to receive reasonable compensation from the medical group requesting consultation on account of any consulting services so rendered.

The Medical Subcommittee of the Retirement Committee shall have the right, at any time and from time to time, to prescribe conditions to the receipt or continued receipt of benefits hereunder by retiring or retired Participants. Such conditions shall, insofar as possible, apply uniformly to all such retiring and retired Participants.

The disqualification established by this Section shall extend to all payments to which the retired Participant or his personal representatives or any beneficiary whose right to any such payment is derived from the eligibility of the Participant for benefits hereunder would otherwise be entitled; provided, however, that the Trustee shall be under no obligation to recover from any such Participant, representative or beneficiary any payments which may have been made between the occurrence of a disqualifying event and the discontinuance of payments.

Section F-5. Determination of Disqualification.

Health Plan, Medical Group, and any Participant, may advise the Trustee of facts indicating that any retired Participant has become disqualified under the provisions of Section F-5, and upon receipt of any such advice the Trustee shall make an investigation and shall determine whether or not such retired Participant has become disqualified; provided, however, that in the event the Trustee's determination is adverse to the retired Participant, he or his successor or successors in interest may, by written application to the Trustee made within six (6) months after written advice of the determination, have such determination reviewed by the Retirement Committee. The decision of the Retirement Committee on any such review shall be final and conclusive on all persons interested.

Article G.

Alternative Distribution Provisions

Section G-1. Permanent Disability.

If a Participant, prior to qualifying for a retirement

benefit, suffers a disability of a substantially permanent nature sufficient to preclude him from conducting a normal medical practice, his entitlement to benefits hereunder shall be the same as though he were qualified for a retirement benefit and had retired as of the date on which such permanent disability is determined to have commenced.

All determinations relating to disability required for the administration of this Section shall be made by a panel of three (3) physicians to be chosen by the Retirement Committee. Any Participant claiming to qualify for benefits under this Section G-1 shall submit to all reasonable examinations and other investigations which the panel may require. The panel shall act by a majority vote and shall certify its findings as to disability to the Trustee; such findings as so certified shall be conclusive as to the claim involved and binding on all parties interested hereunder.

The Committee may establish and amend standards, for determining disability, for the guidance of any panel appointed hereunder; provided, however, that such standards must be of general applicability and not prepared or amended with respect to conditions peculiar to any particular case.

Section G-2. Return to Practice after Permanent Disability.

If a Participant who has been certified to be permanently disabled should return to practice in association with Medical Group, or an Affiliated Medical Group, such return shall not affect any benefits to which he is entitled under Section G-1, and in connection with such new association he shall be treated in all respects as a physician who has become associated with Medical Group or an Affiliated Medical Group for the first time; provided, however, that such physician may, subject to the approval of the Insurer, have his retirement benefits terminated and have the cash equivalent thereof at the date of such termination restored to his tentative individual account to augment such benefits as might be subsequently credited to such account; provided further, that in such event, regardless of any other standards of qualification for retirement benefits, he shall also be deemed so qualified, effective as of the date on which he attains the age of sixty-five (65) years.

Section G-3. Death Prior to Commencement of Benefits.

If a Participant dies before he has received his first

monthly retirement benefit, the amount credited and to be credited to his tentative individual account may be applied in accordance with such Participant's election, either

a. To purchase an annuity or annuities at rates then current for individual annuities for the beneficiary or beneficiaries designated by him; or

b. Paid to such beneficiary or beneficiaries in a lump sum; or

c. Paid to such beneficiary or beneficiaries, together with interest thereon, in such number of equal annual installments, not to exceed five (5), as the Participant shall have designated; or

d. Paid or applied in such other manner as may be permitted by the applicable master contract.

If a Participant dies with no other designation in force, the amount so credited to his account shall be payable to his estate.

Article H.

Reorganization, Dissolution and Transfer

In order to permit, to the fullest practical extent, the continuity of this Trust Agreement and of arrangements made pursuant hereto, regardless of reorganization, dissolution or other organizational change within Medical Group, and transfer of Physicians between Medical Group and Affiliated Medical Groups without adverse effect upon benefits hereunder, the following arrangements are made:

Section H-1. Transfers of Individual Physicians.

Subsection H-1.a. Transfer from Medical Group.

In the event that any Participant shall terminate his association with Medical Group, and shall, within not to exceed three months thereafter (plus any time allowable to such Participant as a leave of absence without interrupting Continuous Full-time Association), become associated with an Affiliated Medical Group, he shall be deemed transferred. The transfer of a Participant from association with Medical Group shall not constitute a break in the Participant's Continuous Full-time Association under this Trust Agreement, nor terminate his status as a Participant.

Subsection H-1.b. Transfer to an Affiliated Medical Group.

If a Participant transfers to an Affiliated Medical Group, as provided in Section H-1.a., the following provisions shall apply:

i. The amount credited to the Participant's tentative account as of his date of transfer shall be determined, and the provisions of Section E-4 shall apply with respect to any amounts to be credited thereafter for services rendered during the year of transfer.

ii. The Participant's tentative account shall be deemed to be suspended and the amount determined in accordance with Subsection H-1.b.i. shall be held at interest until the Participant terminates his association with the Affiliated Medical Group (other than to transfer back to Medical Group or to another Affiliated Medical Group), retires, becomes permanently disabled, or dies. The interest rate to be used during such period of suspension shall be that guaranteed under the insurance contract, if any, or otherwise that generally credited to all other accounts held under the Trust during the period of suspension.

iii. At the time of the Participant's death, retirement, permanent disability, or termination of association (other than to transfer back to the Medical Group, or to another Affiliated Medical Group), he shall be treated as though he had, immediately prior to such time, been associated with Medical Group, and he shall be given credit for Continuous Full-time Association to such time hereunder.

Subsection H-1.c. Transfer from an Affiliated Medical Group.

In the event that any physician shall terminate his association with any Affiliated Medical Group, and shall, within not to exceed three months thereafter (plus any time allowable to such physician as a leave of absence without interrupting Continuous Full-time Association), become associated with Medical Group, he shall be deemed transferred. In the event a physician transfers from an Affiliated Medical Group, the physician shall be allowed the same amount of Continuous Full-time Association under the retirement plan established by this Trust Agreement as he had accrued immediately prior to the date of transfer with the Affiliated Medical Group or, if such Affiliated Medical Group has not

instituted a trust and retirement plan similar to this Trust, the amount of Continuous Full-time Association he would have had, if this Trust and retirement plan had been adopted by such Affiliated Medical Group.

Subsection H-1.d. Eligibility of Transferring Physician.

If a physician transfers to Medical Group in accordance with Subsection H-1.c., the following provisions shall apply:

i. If on the date of transfer the physician is credited with Continuous Full-time Association in an amount equal to two full years plus the time e[illegible]ved prior to the date of transfer during the calendar ye[illegible] during which the transfer takes place, he shall be immediately eligible to participate under this Trust and may become a Participant by executing an election to participate in accordance with Section D-2. The number of units to be allocated to such Participant for service throughout the remainder of the calendar year shall be determined in accordance with Section E-4.

ii. Any transferred physician not immediately eligible in accordance with Sub-Subsection H-1.d.i. shall become eligible on the July 1 coinciding with or next following the date on which he completes two years of Continuous Full-time Association.

Section H-2. Medical Group Reorganization, Dissolution or Other Organizational Change.

Subsection H-2.a. Effect of Medical Group Reorganization, etc.

No reorganization, dissolution, or other change in organizational structure of Medical Group shall cause or require any disposition of tentative accounts maintained pursuant to this Agreement provided at least 50% in number of the Participants (after excluding previously transferred and retired Participants) in Medical Group (as established by the most recent certificate of eligibility filed by Medical Group pursuant to Section D-3) shall, within one year after such reorganization, dissolution or other change in organizational structure, be or become associated with the Medical Group in reorganized form or with any Affiliated Medical Group.

Subsection H-2.b. Forfeitures Occasioned under Subsection H-2.a.

If, as a result of any reorganization, dissolution or other change in organizational structure within the scope of subsection H-2.a., any Participant terminates his association with Medical Group and does not transfer to an Affiliated Medical Group, and if, as of the date of such termination, such Participant has not qualified for a retirement benefit, his tentative rights under this Trust Agreement shall be forfeited; provided however that this subsection shall not apply if as a result of such reorganization, dissolution or other change, this Trust Agreement is terminated pursuant to Section H-3.

Section H-3. Termination of Trust Agreement.

Subsection H-3.a. Transfer of Trust Assets.

If, in connection with the reorganization or dissolution of Medical Group, or otherwise, Health Plan and Medical Group shall jointly determine that some other retirement or deferred compensation plan or plans will better serve to provide retirement benefits for the Participants, or more advantageously effect the purposes of this Trust, the Trustee shall, upon the joint written instructions of the Health Plan and Medical Group, transfer all or any portion of the assets of the Trust to another trustee, insurance company or other organization, corporation or person to apply toward funding such other retirement or deferred compensation plan or plans.

Subsection H-3.b. Dissolution, etc., not Provided for Above.

In the event of any reorganization, dissolution or other organizational change not falling within the scope of Section H-2 and in which no complete disposition of trust assets is effected pursuant to Subsection H-3.a., then, all remaining assets held under this Trust Agreement shall be liquidated as promptly as practical; the funds resulting from such liquidation shall be allocated to tentative individual accounts not otherwise disposed of, and the net balances thereof, after all expenses, if any, incident to such liquidation have been paid, shall be distributed by lump-sum payment to the Participants entitled thereto or their respective nominees.

Article J.

Supervisory Committees

To supervise the administration of this Trust Agreement and assist and guide the Trustee in the performance of its functions hereunder, committees with composition and authority as hereafter set forth shall be established.

Section J-1. Retirement Committee.

There shall be established a Retirement Committee, consisting of the following members:

a. Two members to be designated by Health Plan;
b. Four members to be designated by Medical Group. At least three of the members designated by Medical Group shall be medical doctors;
c. One member, not directly associated with Medical Group, to be selected by majority vote of the remaining members of the committee. It is contemplated, but not required, that this member shall be technically qualified as an actuary, insurance consultant, attorney familiar with retirement and deferred compensation matters, or through other similar qualification, to advise the remaining members of the Retirement Committee in a technical capacity.

In addition to the functions specifically delegated to the Retirement Committee under this Trust Agreement, the Retirement Committee shall advise the Trustee with respect to any questions which may arise in the administration of this Trust, and the Trustee shall be entitled to rely on and shall have no liability for carrying out in good faith advice so given by the Retirement Committee.

Each member of the Retirement Committee shall serve until he shall resign or be replaced. Any member of the committee may be replaced at any time by the organization, group or groups entitled under the foregoing provisions to appoint such member.

Section J-2. Medical Subcommittee of Retirement Committee.

There shall be established a Medical Subcommittee of

the Retirement Committee, consisting of three medical doctors who must be members of the Retirement Committee; the members of this subcommittee shall be selected by and shall serve at the pleasure of the Retirement Committee. The Medical Subcommittee of the Retirement Committee shall perform the functions designated in Section F-4, such other functions as may be delegated to such subcommittee under this Trust Agreement and such other functions as the Retirement Committee shall delegate to the Medical Subcommittee.

Section J-3. Committee Procedure.

No particular formalities shall be required for the transaction of business by the Retirement Committee or the Medical Subcommittee, and said Committees may establish their own rules or practices for the conduct of business; provided, however, that the following minimum standards shall be observed:

a. *Notice.* All committee members shall be given notice of, and a reasonable opportunity to attend, all committee meetings, which notice may be evidenced by waiver or written acknowledgment of notice signed before, at or after the meeting.

b. *Quorum.* A majority of the members of the committee shall be required to constitute a quorum.

c. *Vote required.* The vote or other action of a majority of the members of the committee present at any meeting at which a quorum is present shall constitute the action of the committee.

d. *Minutes.* Simple minutes reflecting major transactions of the committee taken at committee meetings shall be maintained.

e. *Action without a Meeting.* To whatever extent the committee may authorize at a meeting of the committee, a majority of the members of the committee may execute documents and otherwise transact business on behalf of the committee without a committee meeting. A record of all actions taken and a copy of all documents executed in such fashion shall be maintained with the records of the committee.

f. *Unanimous Action by Written Instrument.* Notwithstanding the foregoing provisions, the Retirement Committee may, without further authorization, take any action

or make any decision, which could otherwise be taken or made at a meeting of the committee, by letter, memorandum or resolution signed or concurred in by all members of the Retirement Committee; and any document executed by all members of the Retirement Committee shall constitute an act of the committee.

The foregoing standards shall apply to the Medical Subcommittee as well as to the Retirement Committee, except that the Medical Subcommittee need not hold meetings separate from or maintain records separate from those of the Retirement Committee; however, the transactions of the Medical Subcommittee shall be identified as such.

Article K.

Appointment, Powers and Compensation of Trustee

Section K-1. Appointment of Trustee and Successor Trustees.

Bank of America National Trust and Savings Association is hereby appointed Trustee under this Trust Agreement, effective upon acceptance of this Trust. In the event that said Bank shall decline to accept this Trust, another initial trustee may be designated by Health Plan and Medical Group acting jointly. Any trustee under this Trust Agreement may resign on ninety (90) days' written notice. Any trustee under this Trust Agreement may be discharged by the Retirement Committee on ninety (90) days' written notice. In the event of resignation or discharge of any trustee under this Trust Agreement, a successor trustee may be selected by the Retirement Committee, and promptly upon demand by such successor trustee, the resigning or discharged trustee shall turn over all Trust assets and records to the successor trustee.

Section K-2. Powers of Trustee.

Subject to the express limitations and provisions contained elsewhere in this Trust Agreement, and while acting in furtherance of the general purposes of this Trust Agreement, the Trustee shall have full management powers with respect to all assets of this Trust, including, but not by way of limitation, full power in the discretion of the Trustee to:

a. Invest and reinvest Trust assets and change Trust

investments without regard to any particular list or lists of investments authorized or recommended for trustees;

b. Enter into and carry out contracts of any kind or description;

c. Execute documents of any kind or description, including, but not as a limitation, documents of transfer, assignment, release, compromise, settlement, or reports, returns, applications, statements, assurances or other documents of any form;

d. Settle, compromise, prosecute or defend claims by or against the Trust through informal, administrative or judicial channels.

e. Deal with any governmental agency and take such actions and execute such documents as may be necessary or convenient in connection therewith;

f. Take any and all other actions which may be necessary or convenient in carrying out the purposes of this Trust Agreement or exercising any of the foregoing more specific powers.

The trustee shall not be subject to the control of the Retirement Committee except as expressly provided elsewhere in this Trust Agreement, but the Trustee may at any time, in its discretion, request advice or assistance from the Retirement Committee in carrying out the duties of the Trustee under this Trust Agreement, and the Trustee shall have no liability to any party to this Trust Agreement, to any Participant, or to any person who is a beneficiary, directly or indirectly, of this Trust Agreement on account of any action taken by it in an attempt in good faith to carry out any advice or instruction of the Retirement Committee.

Section K-3. Compensation and Reimbursement of Trustee.

From contributions received pursuant to Section B-2, Trustee shall be entitled to retain an amount equal to all costs or expenses paid or incurred by it which are directly attributable to the administration of this Trust, together with a reasonable trustee's fee consistent with trustees' practice in the administration of trusts involving comparable duties, which trustee's fee shall, however, be subject to the approval of the Retirement Committee. As illustrative of, but not as a limitation upon, the costs and expenses allowable to the Trustee hereunder, the following items are enumerated:

a. Any expenses which the Trustee or the Retirement Committee necessarily incur in carrying out their duties and functions hereunder, including the fees and other expenses of any panel appointed for the determination of a physician's disability, or of any consultants, investigators, attorneys or other agents engaged by the Trustee with the approval of the Retirement Committee, or by the Retirement Committee, in carrying out any functions necessary in the administration of this Trust Agreement;

b. Such amounts as shall be necessary to pay any taxes that may be assessed against the Trust;

c. Such amounts as may be necessary to pay any other claim that may be validly established against the Trust, except for claims asserted by Participants or former Participants, by beneficiaries of such Participants, or by other persons whose claims are derived directly or indirectly from a Participant or former Participant;

d. The costs and other expenses, including fees of attorneys, actuaries, accountants or other consultants engaged with the approval of the Retirement Committee incurred in the defense of any claim asserted against the Trust, the Trustee or the Retirement Committee, except for claims asserted by Participants or former Participants, by beneficiaries of such Participants, or by other persons whose claims are derived directly or indirectly from a Participant or former Participant.

Section K-4. Duties of Trustee.

In addition to such duties as may be expressed elsewhere in this Trust Agreement or incidental to the administration hereof, the Trustee shall furnish such reports and statements as may be reasonably required by the Retirement Committee in connection with the administration of this Trust.

Section K-5. Limitations on Trustee's Liability.

The Trustee shall not be liable for any action taken or omitted in good faith and reasonably believed by the Trustee to be authorized or within the discretion or rights or powers conferred on the Trustee by this Trust Agreement, unless the Trustee is grossly negligent in such conduct.

Section K-6. Rules and Regulations.

The Trustee shall have power to establish such procedural rules in addition to those expressly provided for hereunder as the Trustee may deem necessary for the proper administration of this trust.

Article L.

Miscellaneous Provisions.

Section L-1. Claims of Participants.

In the event that any Participant, former Participant, beneficiary of a Participant, or other person asserting any right hereunder derived directly or indirectly from a Participant, shall assert a claim under this Trust Agreement, which claim is denied or contested in good faith by any party to this Agreement, by the Trustee or by the Retirement Committee, then the following rules shall govern the utilization of Trust assets in the defense of settlement of such claim; all costs, including attorneys' fees and fees of actuaries, accountants or other consultants, investigators or other agents reasonably engaged in the defense of such claim shall be charged against the tentative individual account, if any, of the Participant or former Participant asserting such claim or through whom such claim is allegedly derived; if pursuant to any such claim a judgment or decree is awarded against any party to this Agreement, against the Retirement Committee, or against the Trustee, the balance, if any, remaining in the tentative individual account of the Participant or former Participant by whom such claim is asserted or through whom such claim is derived, shall be applied in satisfaction of such judgment or decree, but no other assets of this Trust shall be so applied.

Section L-2. Nonassignability of Interests.

No interest or claim of interest of any kind under the provisions of this Trust Agreement shall be assignable, nor shall any such interest or claim be subject to garnishment, attachment, execution or levy of any kind, and no attempt to transfer, assign, pledge or otherwise encumber or dispose of such interest by act of the person involved or by operation of law shall be recognized by the Trustee (except as expressly permitted by the settlement provisions of Articles F and G, except insofar as recognition of such action may be required by law.

Section L-3. Limitations on Liability.

The parties to this Trust Agreement, all Participants hereunder, and all persons who may have any rights hereunder derived from any Participant, accept this Trust Agreement, all provisions hereof, including all arrangements for the administration of this Trust, and all provisions of agreements or other documents executed pursuant hereto, without qualification or recourse, except as expressly provided herein, and neither the Retirement Committee nor the Medical Subcommittee, nor any member of any such Committee, nor any party to this Trust Agreement, shall have any liability on account of any action taken or omitted in good faith pursuant hereto.

Section L-4. Amendment.

This Trust Agreement may be amended at any time by instrument in writing executed by Health Plan and by Medical Group, provided, however, that no amendment which substantially affects the rights or responsibilities of the Trustee hereunder shall be effective unless and until the Trustee assents in writing to such amendment.

Section L-5. Interpretation of Trust Agreement.

This Trust Agreement shall be interpreted and administered in accordance with the laws of the State of California.

Executed as of the day and year first mentioned above.

The foregoing Trust Agreement and the Trust thereby established is accepter this 30 day of December 1959.

BANK OF AMERICA
N. T. & S. A.,
As Trustee

By Wilfred J. Heath
Trust Officer

By Geo. T. Reed
Assistant Trust Officer

KAISER FOUNDATION HEALTH PLAN, INC.
A California Nonprofit Corporation

By [Illegible]
Executive Vice President

THE PERMANENTE MEDICAL GROUP
A Limited Partnership of Physicians

By C. C. Cutting, M.D.
By A. J. Sender, M.D.

THE DE KRUIF, ECKHARDT, MOTT, RUBIN, STRICKER MEDICAL GROUP
A Partnership of Physicians

By John M. Mott, M.D.
By [Illegible], M.D.

TRUST AGREEMENT

Retirement Plan for The Permanente Medical Group

ALLOCATION FORMULA

In accordance with the provisions of Section E-2, the unit allocation formula to be used for the purpose of assigning units to Participants for each Fiscal Year's association shall be expressed as $(A+(A\times B\times C)\times E$; assuming the letters used in said formula have the following meanings:

"A" means a Participant's Salary Unit—one unit for each $10 of his basic monthly compensation rate.

"B" means a Participant's Past Service Credit—the number of years, if any, in excess of 2, of his Continuous Full-time Association as of June 30, 1959, said Continuous Full-time Association being conclusively shown in Schedule 1, attached, except for transferred Participants.

"C" means a Participant's Past Service Unit Factor—if the Participant has been credited with Past Service, as determined in accordance with factor B above, the factor shown in Schedule 2, attached, opposite his age on June 30, 1959, except that:

(1) if such Participant has been transferred from an Affiliated Medical Group which has a similar retirement income plan, the *age* to be used to determine factor C shall be that used by such Affiliated Medical Group, and

(2) if such Participant has been transferred from an Affiliated Medical Group which has not established a similar retirement income plan, the age to be used to determine factor C shall be the Participant's age on the date he first becomes eligible for coverage hereunder.

"E" means a Participant's Entry Age Factor—the factor shown in Schedule 3, attached, opposite the Participant's age on the date he became a Participant, except that:

(1) if such Participant has been transferred from an Affiliated Medical Group which has a similar retirement income plan, the age to be used to determine factor E shall be that used by such Affiliated Medical Group, and

(2) if such Participant has been transferred from an

Affiliated Medical Group which has not established a similar retirement income plan, the age to be used to determine factor E shall be the Participant's age on the date he first becomes eligible for coverage hereunder.

ALLOCATION FORMULA

Schedule of Continuous Full-time Association

Name of Participant	Continuous Full-time Association as of June 30, 1959 to nearest year
Aberle, Seymour	4 years
Adams, Julius T.	8 "
Adams, Pearl I.	8 "
Aker, Cecil G.	11 "
Anderson, John R.	4 "
Anderson, Neil E.	4 "
Andrews, Elizabeth T.	7 "
Ash, Donald W.	15 "
Aull, Keith	7 "
Bado, Luis D.	5 "
Ball, Harold C.	2 "
Baltz, Davis A.	4 "
Baritell, August L.	17 "
Bassis, Milton L.	3 "
Basye, James A.	11 "
Bell, Dorothy	11 "
Bien, Charles W.	7 "
Birch, Ronald S.	3 "
Black, H. Donald	3 "
Boal, Robert W.	2 "
Bolomey, Alfred A.	10 "
Briske, John P.	3 "
Broderick, Richard B.	5 "
Brody, Burton	6 "
Budai, Benedict S.	5 "
Bulgarelli, Rino	5 "
Burke, Robert H.	3 "
Burnett, Richard C.	2 "
Burnip, Sidney R.	5 "
Burns, Margaret	3 "
Calderwood, George C.	5 "
Cantrell, Mary E.	2 "

Name of Participant	Continuous Full-time Association as of June 30, 1959 to nearest year
Carmel, Jr., Willard J.	8 years
Cary, William S.	6 "
Chisholm, Eugene R.	7 "
Clark, Gilbert	3 "
Clinkston, Philip H.	4 "
Cogswell, Robert C.	9 "
Cohen, Solomon	4 "
Collen, Morris F.	17 "
Collier, Ella Mary	5 "
Comroe, Leon B.	6 "
Comroe, Jules B.	5 "
Constantz, Robert B.	5 "
Cook, Wallace H.	7 "
Copeland, Joseph	10 "
Cutting, Cecil C.	17 "
Dannenberg, Thur[illegible]n B.	14 "
DeFranco, Samuel L.	3 "
DeKruif, David	10 "
Dennis, Robert	8 "
Dicken, Dorothy M.	6 "
Diller, Howard A.	4 "
Dohner, Richard E.	3 "
Donchin, Jerome H.	5 "
dos Remedios, Leonard V.	7 "
Doss, John F.	3 "
Drori, Jack B.	2 "
Dunn, Fa-Chi	4 "
Eads, William S.	4 "
Eckhardt, George C.	6 "
Eldred, Roy E.	4 "
Feingold, Benjamin F.	8 "
Fernandes, David A.	9 "
Files, Ernest H.	5 "
Fisher, Carl W.	10 "
Fishler, Maurice C.	4 "
Fishman, Louis Z.	5 "
Fleming, Marian	5 "
Flett, Jr., James	7 "

Name of Participant	Continuous Full-time Association as of June 30, 1959 to nearest year
Flint, Jr., Thomas R.	13 years
Follette, William T.	3 "
Frank, Jr., Leo James	4 "
Freedman, William B.	5 "
Friedman, Melvin F.	13 "
Gans, Edward W.	11 "
Garcia, Carlos V.	7 "
Gavce, Jerry W.	5 "
Geier, Frederick M.	11 "
Gilkey, Jack V.	8 "
Goodman, Clifford S.	7 "
Gordon, Milton E.	6 "
Gottlieb, Frederick I.	4 "
Grant, H. Donald	16 "
Grinbergs, Anna E.	5 "
Hahne, Leonard J.	4 "
Hall, Thomas N.	5 "
Haney, Catherine A.	5 "
Hannah, Richard McCall	4 "
Harmon, Paul H.	2 "
Harris, Leon E.	5 "
Haugen, Norman L.	16 "
Hayashida, Michihiko	4 "
Hedberg, William C.	5 "
Henricks, Ann	2 "
Herbert, Charles C.	5 "
Herschel, Paul E.	3 "
Hollister, James K.	6 "
Holmboe, Harris S.	12 "
Horn, Maurice	4 "
Hotchkiss, John E.	4 "
Hunter, Jep S.	6 "
Hunter, William S.	8 "
Hurlbutt, Frank R.	5 "
Jannetti, William A.	4 "
Jansen, Maria Elizabeth	5 "
Jantzen, John C.	12 "
Jenkins, Leonie L.	4 "

Name of Participant	Continuous Full-time Association as of June 30, 1959 to nearest year
Jensen, Roy D.	7 years
Kahn, Bernard I.	5 "
Kaufman, Kimball C.	4 "
Kaye, Edward F.	3 "
Kelly, Frank J.	3 "
King, Alexander L.	12 "
King, Robert W.	14 "
Kirby, Harry W. B.	11 "
Knigge, William T.	11 "
Koel, Bertram S.	4 "
Koulischer, Nina	2 "
Kremser, Elizabeth L.	4 "
Krombout, George A.	7 "
Krusich, Georgia N.	11 "
Kubota, Chrysanthia K.	3 "
Kuldvere, Ebba	4 "
Kwan, Sung T.	7 "
Lake, Thomas L.	5 "
Lawson, William R.	8 "
Leeper, Roy W.	6 "
Lei, Beatrice	15 "
Lelich, Bronko P.	4 "
Lenel, Rosemarie	9 "
Leppmann, Marianne H.	4 "
Lethin, Anton N.	3 "
Levatin, Paul	10 "
Lichtenstein, Robert M.	3 "
Linder, Anatol J.	6 "
Linville, John L.	6 "
Lobel, Charles I.	5 "
Lomhoff, Irving I.	11 "
Loutzenheiser, Joyce	5 "
Loveseth, Leonard J.	4 "
Lovitt, John L.	7 "
Lynn, Carroll L.	2 "
MacDonald, Donald	3 "
Mackby, M. Judson	3 "
Makepeace, Alexander W.	8 "

Name of Participant	Continuous Full-time Association as of June 30, 1959 to nearest year
Marchand, Richard J.	4 years
Mayo, J. Palmer	4 "
McCune, Donovan J.	7 "
McGinley, James	6 "
McNeil, John H.	4 "
Mead, Sedgwick	5 "
Meffert, Henry	2 "
Mendelsohn, Eugene Sheldon	2 "
Mendelsohn, Mary G.	2 "
Michels, Merrill W.	13 "
Milefsky, Leonard C.	8 "
Morgenstern, Nathan L.	5 "
Mortarotti, Talbot	4 "
Mott, John M.	9 "
Mukerji, Sasanka	3 "
Muller, Henry J.	4 "
Myatt, Albert V.	3 "
Narverud, Raymond A.	4 "
Neighbor, J. Wallace	17 "
Nelson, H. Bristol	6 "
Newey, James A.	5 "
Nieda, Isamu	5 "
Nussbaum, Herman	5 "
Ogilvie, Robert J.	2 "
Olpin, Harold W.	4 "
Olwin, Thomas Kent	2 "
Orski, Barbara M.	2 "
Owen, Lloyd H.	5 "
Parsens, Darold J.	4 "
Pease, John A.	2 "
Pellegrin, Frederick A.	10 "
Perloff, Phillip	6 "
Pietropaoli, Remo	4 "
Pooley, Mary L.	4 "
Poort, John N.	7 "
Raimondi, Phillip J.	15 "
Raphael, Ellen Gunther	4 "
Raphael, James C.	2 "

Name of Participant	Continuous Full-time Association as of June 30, 1959 to nearest year
Reichenberg, Stanley	3 years
Renoir, Maurice P.	6 "
Resnick, Bernard	2 "
Revis, Nicholas T.	6 "
Rhodes, Bernard L.	6 "
Ritter, Jr., Daniel	6 "
Robson, Philip G.	9 "
Rosenthal, Joseph H.	2 "
Roth, Arthur	7 "
Roth, Leonard	7 "
Rousseau, Paul	11 "
Rubin, Leonard	6 "
Saeed, Yunis M.	3 "
Santomieri, Louis S.	5 "
Sategna, James	10 "
Schaaf, Frederick C.	5 "
Schiller, Francis	5 "
Schoen, Edgar J.	5 "
Schwartz, Herman A.	5 "
Seidman, Alexander	6 "
Sender, A. Joseph	8 "
Shannon, Edward P.	4 "
Shearn, Martin	4 "
Shenk, Morris J.	8 "
Singer, Bella	5 "
Smillie, John G.	10 "
Smith, Jr., P. Dunlap	5 "
Snowden, Vernon L.	11 "
Soghikian, Krikor	4 "
Sorokowski, Nadia	5 "
Southerland, Robert W.	4 "
Speer, Evans	5 "
Stange, Paul E.	6 "
Stanton, W. K.	3 "
Stathakos, Peter N.	5 "
Steadman, Monte G.	8 "
Stein, George H.	6 "
Steinhardt, David	7 "

Name of Participant	Continuous Full-time Association as of June 30, 1959 to nearest year
Sweeny, Edward W.	4 years
Sweet, Rex E.	3 "
Tai, Shou Nan	2 "
Takahashi, Kazuyuki	6 "
Taylor, Billy B.	4 "
Thal, F. Joseph	7 "
Thompson, Roderick I.	10 "
Townsend, James D.	3 "
Traurig, Estelle	3 "
Treubel, Fredrick W.	4 "
Troutner, Leonard P.	5 "
Utter, Henry M.	6 "
Uyeda, Clifford I.	5 "
Vrcon, Stanley	2 "
Wang, Hsien Fen	3 "
Weber, Paul M.	4 "
Welts, Robert V.	5 "
Williams, Winfield T.	2 "
Willner, Charles E.	2 "
Winters, Harold S.	8 "
Wood, Gordon K.	3 "
Woodruff, William Egleston	2 "
Young, John R.	4 "
Zach, Frank S.	3 "

Allocation Formula

Past Service Unit Factors

Age, nearest birthday, as of June 30, 1959	Past Service Unit Factor
64	1.03
63	.52
62	.35
61	.27
60	.22
59	.18
58	.16
57	.14
56	.13
55	.12
54	.11
53	.10
52	.09
51	.09
50	.08
49	.08
48	.07
47	.07
46	.07
45	.07
44	.06
43	.06
42	.06
41	.06
40	.06
39	.05
38	.05
37	.05
36	.05
35	.05
34	.05

Age, nearest birthday, as of June 30, 1959	Past Service Unit Factor
33	.05
32	.05
31	.05
30 or younger	.04

ALLOCATION FORMULA
Entry Age Factors

Age, nearest birthday at entry into Program	Entry Age Factor
27	1.000
28	1.036
29	1.073
30	1.113
31	1.154
32	1.199
33	1.245
34	1.295
35	1.348
36	1.404
37	1.465
38	1.513
39	1.566
40	1.621
41	1.680
42	1.743
43	1.812
44	1.885
45	1.966
46	2.052
47 and over	2.148

APPENDIX A
Schedule 3
Effective July 1, 1960

ALLOCATION FORMULA

Entry Age Factors

Age, nearest birthday at entry into Program	Entry Age Factor
27	1.000
28	1.028
29	1.057
30	1.087
31	1.117
32	1.148
33	1.179
34	1.211
35	1.244
36	1.278
37	1.312
38	1.347
39	1.383
40	1.419
41	1.456
42	1.494
43	1.533
44	1.573
45	1.613
46	1.654
47	1.696
48	1.738
49	1.781
50	1.826
51	1.871
52	1.917
53	1.963
54	2.010
55	2.059
56	2.109
57	2.148
58	2.148
59	2.148
60	2.148

Age, nearest birthday at entry into Program	Entry Age Factor
61	2.148
62	2.148
63	2.148
64	2.148

First Amendment to Trust Agreement

(Retirement Program for Eligible Participants Associated with The Permanente Medical Group)

Effective as of July 1, 1960, the allocation formula set forth in Appendix A attached to the Trust Agreement effective July 1, 1959 among Kaiser Foundation Health Plan, Inc., The Permanente Medical Group and Bank of America National Trust and Savings Association that establishes a retirement income program for Participants qualifying under the provisions of said Trust Agreement is amended by deleting Schedule 3 therefrom and substituting in lieu thereof the revised Schedule 3 attached to this Amendment, provided, however, that the original Schedule 3 deleted by this Amendment shall govern allocations covering the period prior to July 1, 1960.

Executed at Oakland, California as of the day and year first mentioned above.

The Permanente Medical Group
A Limited Partnership of Physicians

By C. C. Cutting, M.D.

Kaiser Foundation Health Plan, Inc.
A California Nonprofit Corporation

By (Illegible)
Vice President

Approved and Accepted
this 30 day of June, 1961
Bank of America National Trust and
Savings Association, as Trustee

By (Illegible)
Trust Officer

By A. D. Vierra
Asst. Trust Officer

Revised Allocation Formula
The Permanente Medical Group

Age at Entry Into Program	Past Service	Entry Age
27	.04	1.000
28	.04	1.028
29	.04	1.057
30	.04	1.087
31	.05	1.117
32	.05	1.148
33	.05	1.179
34	.05	1.211
35	.05	1.244
36	.05	1.278
37	.05	1.312
38	.05	1.347
39	.05	1.383
40	.06	1.419
41	.06	1.456
42	.06	1.494
43	.06	1.533
44	.07	1.573
45	.07	1.613
46	.07	1.654
47	.07	1.696
48	.07	1.738
49	.08	1.781
50	.08	1.826
51	.09	1.871
52	.09	1.917
53	.10	1.963
54	.11	2.010
55	.12	2.059
56	.13	2.109
57	.14	2.148
58	.16	2.148
59	.18	2.148
60	.22	2.148
61	.27	2.148
62	.35	2.148
63	.52	2.148
64	1.03	2.148

Second Amendment to Trust Agreement

(Retirement Program for Eligible Participants Associated with The Permanente Medical Group)

Effective as of July 1, 1960, the allocation formula set forth in Appendix A attached to the Trust Agreement executed effective July 1, 1959 by Kaiser Foundation Health Plan, Inc., The Permanente Medical Group and Bank of America, National Trust and Savings Association, establishing a retirement income program for participants qualifying under the provisions of said Trust Agreement, is amended by striking therefrom the revised Schedule 3 set forth in that certain First Amendment to the Trust Agreement executed effective July 1, 1960 and by reinstating in said Appendix A of said Trust Agreement Schedule 3 as the same originally appeared in said Appendix A of said Trust Agreement when first executed.

Executed at Oakland, California as of the day and year first above mentioned.

The Permanente Medical Group
A Limited Partnership of Physicians

By C. C. Cutting, M.D.

Kaiser Foundation Health Plan, Inc.
A California Nonprofit Corporation

By Clifford H. Keene

Approved and Accepted.

Bank of America, National Trust
and Savings Association

By (Illegible)
Vice President

By Geo. T. Reid
Assistant Trust Officer

Revised Allocation Formula
The Permanente Medical Group

Age at Entry Into Program	Past Service	Entry Age
27	.04	1.000
28	.04	1.028
29	.04	1.057
30	.04	1.087
31	.05	1.117
32	.05	1.148
33	.05	1.179
34	.05	1.211
35	.05	1.244
36	.05	1.278
37	.05	1.312
38	.05	1.347
39	.05	1.383
40	.06	1.419
41	.06	1.456
42	.06	1.494
43	.06	1.533
44	.07	1.573
45	.07	1.613
46	.07	1.654
47	.07	1.696
48	.07	1.738
49	.08	1.781
50	.08	1.826
51	.09	1.871
52	.09	1.917
53	.10	1.963
54	.11	2.010
55	.12	2.059
56	.13	2.109
57	.14	2.148
58	.16	2.148
59	.18	2.148
60	.22	2.148
61	.27	2.148
62	.35	2.148
63	.52	2.148
64	1.03	2.148

Second Amendment to Trust Agreement

(Retirement Program for Eligible Participants Associated with The Permanente Medical Group)

Effective as of July 1, 1960, the allocation formula set forth in Appendix A attached to the Trust Agreement executed effective July 1, 1959 by Kaiser Foundation Health Plan, Inc., The Permanente Medical Group and Bank of America, National Trust and Savings Association, establishing a retirement income program for participants qualifying under the provisions of said Trust Agreement, is amended by striking therefrom the revised Schedule 3 set forth in that certain First Amendment to the Trust Agreement executed effective July 1, 1960 and by reinstating in said Appendix A of said Trust Agreement Schedule 3 as the same originally appeared in said Appendix A of said Trust Agreement when first executed.

Executed at Oakland, California as of the day and year first above mentioned.

The Permanente Medical Group
A Limited Partnership of Physicians

By C. C. Cutting, M.D.

Kaiser Foundation Health Plan, Inc.
A California Nonprofit Corporation

By Clifford H. Keene

Approved and Accepted.

Bank of America, National Trust
and Savings Association

By (Illegible)
Vice President

By Geo. T. Reid
Assistant Trust Officer

SCHEDULE SHOWING HOW FUNDS IN RETIREMENT TRUST ALLOCATED AND DETERMINED FOR EACH YEAR IN ISSUE

(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)	(k)	(l)	(m)	(n)
T/S FISCAL YEAR ENDED	HEALTH PLAN PAYMENTS TO TRUST (I/C) [col. (b), sched. para. 19]	NET INCOME EARNED ON TRUST CORPUS (I/I) [col. (c), sched. para. 19]	TOTAL UNITS UNDER PLAN ALLOCATED ALL PARTICIPANTS RE I/C	UNITS UNDER PLAN ALLOC. P/P RE I/C	AMOUNT OF I/C ALLOC. P/P [(e)÷(d) x(b)]	UNIT VALUE OF I/C ALLOC. P/P [(f)÷(e)]	TOTAL UNITS UNDER PLAN ALLOCATED ALL PARTICIPANTS RE I/I	UNITS UNDER PLAN ALLOC. P/P RE I/I	AMOUNT OF I/I ALLOC. P/P [(i)÷(h) x(c)]	UNIT VALUE OF I/I ALLOC. P/P [(j)÷(i)]	AMOUNT OF I/C PLUS I/I ALLOC. N/P UNDER PLAN [(b)+(c) -(f)-(j)]	TOTAL P/S SHARES DETERMINED RE DIVISION OF PROFITS RATIO	VALUE P P/S SHA OF I/C PLUS I/I ALLOC. [(l)÷(
12/6-30-60	$516,298.68	$ 2,159.74	93,966.09	86,006.93	$473,385.62	$5.50404	(see n. 1)	(see n. 1)	(see n. 1)	(see n. 1)	$45,072.80	197.5	$228.213
				2/83,591.32	$461,215.61	$5.51750					$40,097.79	197.5	$203.02
6-30-61	$573,924.60	$ 3,355.79	98,104.47	91,349.49	$533,297.24	$5.83799	90,735.98	87,809.77	$-3,247.56	$0.03698	$40,735.59	222.5	$183.061
				2/91,249.49	$533,297.24	$5.84438	90,735.98	87,663.36	$ 3,242.16	$0.03698	$40,740.99	222.5	$183.105
-30-62	$606,866.28	$30,290.56	99,065.65	91,959.27	$563,333.31	$6.12590	96,985.56	94,275.70	$29,443.92	$0.31232	$44,379.61	232.81	$190.624
6-30-63	$640,348.68	$26,097.00	99,685.55	93,361.38	$599,724.20	$6.42369	96,874.67	93,717.64	$25,246.53	$0.26939	$41,474.95	249.64	$166.141

KEY: P/S — PARTNERSHIP
I/C — INCREASE IN TRUST CORPUS
I/I — INCREASE IN TRUST INCOME
P/P — PARTNER-PARTICIPANTS IN RETIREMENT PLAN
N/P — NONPARTNER-PARTICIPANTS IN RETIREMENT PLAN
T/P — TAXPAYER

NOTES:

1/ For the initial year of 1960 only, the plan combined corpus and income for purposes of allocation to participants. Columns (d) through (g), and related columns (r) and (s) on the following page, therefore include both corpus and income for 1960 only.

2/ The second-line figures for 1960 and 1961 represent allocation recomputations made by the Internal Revenue Service after the tax deficiencies for all plaintiffs except Sorokowski had been administratively determined and assessed. In the schedule on the following page, showing the increases in plaintiff-taxpayers' income as determined by the Internal Revenue Service for the years in question, only the Sorokowski figures for 1960 and 1961 are based on the second-line recomputations.

SCHEDULE CONTINUED — SHOWING ALLOCATIONS AND DETERMINATIONS FOR EACH PLAINTIFF-TAXPAYER

(o) T/P - P/P (PLAINTIFFS)	(p) T/P TAX YEAR	(q) T/P SHARE OF P/S INCOME PER P/S RETURN	(r) UNITS UNDER PLAN ALLOC. T/P RE I/C [col. (e)]	(s) VALUE OF UNITS ALLOC. T/P RE I/C [(r)x(g)]	(t) UNITS UNDER PLAN ALLOC. T/P RE I/I [col. (i)]	(u) VALUE OF UNITS ALLOC. T/P RE I/I [(t)x(k)]	(v) P/S SHARE OF T/P PER PROFITS RATIO [col. (m)]	(w) VALUE OF T/P SHARE OF I/C PLUS I/I ALLOC. M/P [(v)x(n)]	(x) TOTAL INCREASE DETERMINED IN T/P INCOME RE TRUST [(s)+(u)+(w)]
DR. JAMES BAYSE	1960	$31,837.69	517.44	$2,848.01	-0-	-0-	1	$228.21	$3,076.22
	1961	$33,952.00	530.38	$3,096.35	517.44	$19.14	1	$183.08	$3,298.57
DR. CAROL LYNN COOK	1961	$18,379.00	116.55	$ 680.42	132.71	$ 4.91	0.5	$ 91.54	$ 776.87
DR. MAURICE FISHIER	1960	$27,004.93	347.22	$1,911.11	-0-	-0-	1	$228.21	$2,139.32
	1961	$28,572.00	391.80	$2,287.32	347.22	$12.86	1	$183.08	$2,483.26
DR. DONALD GRANT	1960	$33,982.69	699.15	$3,848.16	-0-	-0-	1	$228.21	$4,076.36
	1961	$36,982.00	737.64	$4,306.33	699.15	$25.86	1	$183.08	$4,515.27
DR. WILLIAM HUNTER	1960	$26,676.79	471.80	$2,596.81	-0-	-0-	1	$228.21	$2,825.02
	1961	$29,301.61	463.43	$2,705.50	471.80	$17.45	1	$183.08	$2,906.03
DR. JESSAMINE HUNTER	1960	$20,647.47	283.42	$1,559.96	-0-	-0-	1	$228.21	$1,788.17
	1961	$23,924.09	243.21	$1,419.86	283.42	$10.48	1	$183.08	$1,613.42
DR. NADIA SOKOLOWSKI	1960	$24,157.69	241.32	$1,331.48	-0-	-0-	1	$203.02	$1,534.50
	1961	$26,346.61	255.73	$1,494.58	241.32	$ 8.92	1	$183.10	$1,686.60
	1962	$26,705.68	244.92	$1,500.35	255.73	$79.86	1	$190.62	$1,770.83
	1963	$24,363.94	244.92	$1,573.28	244.92	$65.97	1	$166.14	$1,805.39

Statement of Forfeitures by Terminating Participants During Fiscal Years Ending in 1960 Through 1963

Name of Participant	Date of Employment	Date of Participation	Date of Partnership	Date of Termination	Tentative Account Balance Forfeited
*Southerland, Robert W.	9-7-54	7-1-59	—	8-15-59	$ 279.24
Chisholm, Eugene R.	4-14-52	7-1-59	7-1-55	11-1-59	805.44
Loutzenheiser, Joyce C.	3-17-54	7-1-59	7-1-58	7-1-60	1,224.88
Muller, Henry J.	6-1-55	7-1-59	7-1-58	7-1-60	2,090.91
Files, Ernest H.	5-1-54	7-1-59	7-1-57	9-30-60	2,490.80
*Meffert, Henry	10-8-56	7-1-59	—	9-30-60	1,520.06
Gordon, Milton E.	8-10-53	7-1-59	7-1-56	3-8-61	2,757.22
*Wood, Gordon K.	7-16-56	7-1-59	—	8-6-61	1,109.36
*Burns, Margaret	7-16-56	7-1-59	—	10-16-61	812.86
Ogilvie, Robert J.	7-1-57	7-1-59	7-1-59	4-1-62	3,098.08
*Roth, George J.	7-1-59	7-1-61	—	5-1-62	682.69
Kremser, Elizabeth L.	7-6-53	7-1-59	7-1-57	8-16-62	2,306.62
Dreri, Jack B.	7-1-57	7-1-59	7-1-60	8-16-62	2,803.88
Gottlieb, Frederick I.	2-14-55	7-1-59	7-1-58	8-31-62	5,611.60
*Henrichs, Ann O.	7-1-60	7-1-59	—	11-15-62	2,240.45
Stone, Bernard	8-4-58	7-1-60	7-1-61	11-30-62	3,703.98
*Fleming, Marian	10-1-53	7-1-59	—	2-1-63	4,452.05
Wang, Hsin Fen	11-28-55	7-1-59	7-1-59	2-1-63	3,189.53
Gilkey, Jack V.	1-2-49	7-1-59	7-1-54	3-1-63	7,409.27
Roth, Arthur	1-1-50	7-1-59	7-1-55	4-1-63	5,512.74
*DeKruif, David	1-3-61	7-1-59	—	4-1-63	3,110.66
*Williams, Francis R.	7-1-60	7-1-62	—	5-11-63	767.98
Vreon, Stanley	6-18-57	7-1-59	7-1-60	5-16-63	4,972.62

* Non-Partner.

May 5, 1967

Cecil F. Poole
United States Attorney
450 Golden Gate Avenue, Box 36055
San Francisco, California 94102

Attention John M. Youngquist
Assistant United States Attorney

Dear Mr. Youngquist:

Sorokowski v. United States
Civil No. 45575

We have received United States Treasury check No. 57,128,129 drawn payable to the order of George W. and Nadia Sorokowski in the amount of $3,875.31, and representing a purported refund of income taxes for the year 1963. As you are aware, we believe that such refund for 1963 was made in error, and that the Sorokowskis are entitled to recover only the sums requested in their pending suit for refund of income taxes, for the years involved in that suit, and for the reasons therein alleged. Accordingly, we have deposited said check in a trust account pending a final judgment in the above action. If you prefer, we will be happy to return the money immediately so that the United States may retain it during the pendency of the above action.

We frankly do not understand why this check was issued in the first place. It represents a refund which the Sorokowskis have never claimed, and to which they do not believe they are entitled. We were certainly not aware that it was the general policy of the United States to volunteer such unsolicited refunds of income taxes.

Cordially yours,

STARK & CHAMPLIN

By John F. Banker
JOHN F. BANKER

EXHIBIT F

Notation re Opinion of District Court

The opinion of the district court is printed in the Petition for Certiorari, and may be found therein at pages 15-29, as Appendix A. It is therefore not reprinted in this Appendix.

UNITED STATES DISTRICT COURT FOR THE
NORTHERN DISTRICT OF CALIFORNIA

[Caption Omitted]

Civil No. 44352
Judgment

This action was consolidated for trial with actions numbered 44353, 44354, 44355, 44356 and 45575, and was submitted for decision pursuant to that certain "Stipulation for Presentation of Cases as Short Cause Under Rules 7 & 9, and Agreed Statements of Facts and Issue" filed March 27, 1968, and the Court having filed its Memorandum of Decision herein on November 29, 1968 wherein appear its findings of fact and conclusions of law,

IT IS ORDERED AND ADJUDGED that plaintiffs James E. Basye and Evelyn E. Basye have judgment against, and recover from, defendant United States of America overpayments of income tax and interest in the sums set forth hereafter, made on the dates hereafter shown, together with interest thereon at 6% per annum to a date preceding the issuance of the refund check by not more than thirty days, such date to be determined by the Commissioner of Internal Revenue, together with plaintiffs' costs to be taxed by the Clerk of the Court in the sum of $.....

Tax Year	Amounts of Overpayment		Dates of Overpayment
1960	Tax	$1,424.02	June 18, 1965
1960	Interest	356.70	June 18, 1965
1961	Tax	1,586.93	June 18, 1965
1961	Interest	302.30	June 18, 1965

Dated: Dec. 11, 1968

/s/ Albert C. Wollenberg
[ALBERT C. WOLLENBERG]
United States District Judge

Approved as to Form:

/s/ John M. Youngquist
JOHN M. YOUNGQUIST
Assistant United States Attorney

UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF CALIFORNIA

[*Caption Omitted*]

Civil No. 44353
Judgment

This action was consolidated for trial with actions numbered 44352, 44354, 44355, 44356 and 45575, and was submitted for decision pursuant to that certain "Stipulation for Presentation of Cases as Short Cause Under Rules 7 & 9, and Agreed Statements of Facts and Issue" filed March 27, 1968, and the Court having filed its Memorandum of Decision herein on November 29, 1968 wherein appear its findings of fact and conclusions of law,

IT IS ORDERED AND ADJUDGED that plaintiffs Jack J. Cook and Carol L. Cook have judgment against, and recover from, defendant United States of America overpayments of income tax and interest in the sums set forth hereafter, made on the dates hereafter shown, together with interest thereon at 6% per annum to a date preceding the issuance of the refund check by not more than thirty days, such date to be determined by the Commissioner of Internal Revenue, together with plaintiffs' costs to be taxed by the Clerk of the Court in the sum of $.....

Tax Year	Amounts of Overpayment		Dates of Overpayment
1961	Tax	$301.04	June 18, 1965
1961	Interest	57.35	June 18, 1965

Dated: Dec. 11, 1968

/s/ Albert C. Wollenberg
[ALBERT C. WOLLENBERG]
United States District Judge

Approved as to Form:

/s/ John M. Youngquist
JOHN M. YOUNGQUIST
Assistant United States Attorney

UNITED STATES DISTRICT COURT FOR THE
NORTHERN DISTRICT OF CALIFORNIA

[*Caption Omitted*]

CIVIL No. 44354
Judgment

This action was consolidated for trial with actions numbered 44352, 44353, 44355, 44356 and 45575, and was submitted for decision pursuant to that certain "Stipulation for Presentation of Cases as Short Cause Under Rules 7 & 9, and Agreed Statements of Facts and Issue" filed March 27, 1968, and the Court having filed its Memorandum of Decision herein on November 29, 1968 wherein appear its findings of fact and conclusions of law,

IT IS ORDERED AND ADJUDGED that plaintiffs Maurice C. Fishler and Phyllis H. Fishler have judgment against, and recover from, defendant United States of America overpayments of income tax and interest in the sums set forth hereafter, made on the dates hereafter shown, together with interest thereon at 6% per annum to a date preceding the issuance of the refund check by not more than thirty days, such date to be determined by the Commissioner of Internal Revenue, together with plaintiffs' costs to be taxed by the Clerk of the Court in the sum of $.....

Tax Year	Amounts of Overpayment		Dates of Overpayment
1960	Tax	$660.87	June 18, 1965
1960	Interest	165.54	June 18, 1965
1961	Tax	869.67	June 18, 1965
1961	Interest	165.66	June 18, 1965

Dated: Dec. 11, 1968

/s/ Albert C. Wollenberg
ALBERT C. WOLLENBERG
United States District Judge

Approved as to Form:

/s/ John M. Youngquist
JOHN M. YOUNGQUIST
Assistant United States Attorney

UNITED STATES DISTRICT COURT FOR THE
NORTHERN DISTRICT OF CALIFORNIA

[Caption Omitted]

CIVIL No. 44355
Judgment

This action was consolidated for trial with actions numbered 44352, 44353, 44356 and 45575, and was submitted for decision pursuant to that certain "Stipulation for Presentation of Cases as Short Cause Under Rules 7 & 9, and Agreed Statements of Facts and Issues" filed March 27, 1968, and the Court having filed its Memorandum of Decision herein on November 29, 1968 wherein appear its findings of fact and conclusions of law,

IT IS ORDERED AND ADJUDGED that plaintiffs Henry Donald Grant and Jean H. Grant have judgment against, and recover from, defendant United States of America overpayments of income tax and interest in the sums set forth hereafter, made on the dates hereafter shown, together with interest thereon at 6% per annum to a date preceding the issuance of the refund check by not more than thirty days, such date to be determined by the Commissioner of Internal Revenue, together with plaintiffs' costs to be taxed by the Clerk of the Court in the sum of $.....

Tax Year	Amounts of Overpayment		Dates of Overpayment
Separate judgment in favor of plaintiff Henry Donald Grant:			
1960	Tax	$ 919.76	June 18, 1965
1960	Interest	230.39	June 18, 1965
Separate judgment in favor of plaintiff Jean H. Grant:			
1960	Tax	919.76	June 18, 1965
1960	Interest	230.39	June 18, 1965
Joint judgment in favor of both plaintiffs:			
1961	Tax	2,236.90	June 18, 1965
1961	Interest	426.12	June 18, 1965

Dated: Dec. 11, 1968

/s/ Albert C. Wollenberg
ALBERT C. WOLLENBERG
United States District Judge

Approved as to Form:
/s/ John M. Youngquist
JOHN M. YOUNGQUIST
United States Attorney

UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF CALIFORNIA

[*Caption Omitted*]

Civil No. 44356
Judgment

This action was consolidated for trial with actions numbered 44352, 44353, 44354, 44355 and 45575, and was submitted for decision pursuant to that certain "Stipulation for Presentation of Cases as Short Cause Under Rules 7 & 9, and Agreed Statements of Facts and Issues" filed March 27, 1968, and the Court having filed its Memorandum of Decision herein on November 29, 1968 wherein appear its findings of fact and conclusions of law,

IT IS ORDERED AND ADJUDGED that plaintiffs William S. Hunter and Jessamine S. Hunter have judgment against, and recover from, defendant United States of America overpayments of income tax and interest in the sums set forth hereafter, made on the dates hereafter shown, together with interest thereon at 6% per annum to a date preceding the issuance of the refund check by not more than thirty days, such date to be determined by the Commissioner of Internal Revenue, together with plaintiffs' costs to be taxed by the Clerk of the Court in the sum of $.....

Tax Year	Amounts of Overpayment		Dates of Overpayment
1960	Tax	$4,094.24	June 18, 1965
1960	Interest	1,025.57	June 18, 1965
1961	Tax	$1,630.92	June 18, 1965
1961	Interest	310.68	June 18, 1965

Dated: Dec. 11, 1968

/s/ Albert C. Wollenberg
ALBERT C. WOLLENBERG
United States District Judge.

Approved as to Form:

/s/ John M. Youngquist
JOHN M. YOUNGQUIST
Assistant United States Attorney

UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF CALIFORNIA

[*Caption Omitted*]

Civil No. 45575
Judgment

This action was consolidated for trial with actions numbered 44352, 44353, 44354, 44355 and 44356, and was submitted for decision pursuant to that certain "Stipulation for Presentation of Cases as Short Cause Under Rules 7 & 9, and Agreed Statements of Facts and Issue" filed March 27, 1968, and the Court having filed its Memorandum of Decision herein on November 29, 1968 wherein appear its findings of fact and conclusions of law,

IT IS ORDERED AND ADJUDGED that plaintiffs George W. Sorokowski and Nadia Sorokowski have judgment against, and recover from, defendant United States of America overpayments of income tax and interest in the sums set forth hereafter, made on the dates hereafter shown, together with interest thereon at 6% per annum to a date preceding the issuance of the refund check by not more than thirty days, such date to be determined by the Commissioner of Internal Revenue, together with plaintiffs' costs to be taxed by the Clerk of the Court in the sum of $.....

Tax Year	Amounts of Overpayment		Dates of Overpayment
1960	Tax	$692.86	April 25, 1966
1960	Interest	208.99	May 24, 1966
1961	Tax	792.70	April 25, 1966
1961	Interest	191.55	May 24, 1966
1962	Tax	873.42	April 25, 1966
1962	Interest	158.65	May 24, 1966
1963	Tax	902.69	April 25, 1966
1963	Interest	109.80	May 24, 1966

IT IS FURTHER ORDERED AND ADJUDGED that defendant, The United States of America, have judgment against, and recover from, plaintiffs George W. Sorokowski and Nadia

Sorokowski by way of set off against the foregoing judgment in favor of plaintiffs the sum of $3,875.31 with interest thereon at the rate of 6% per annum from and after March 8, 1967.

Dated: Dec. 11, 1968.

/s/ Albert C. Wollenberg
[Albert C. Wollenberg]
United States District Judge.

Approved As to Form:

/s/ John M. Youngquist
John M. Youngquist
Assistant United States Attorney.

UNITED STATES DISTRICT COURT FOR THE
NORTHERN DISTRICT OF CALIFORNIA

[*Caption Omitted*]

Civil No. 44352
Notice of Appeal

NOTICE is hereby given that the UNITED STATES OF AMERICA, defendant above named, hereby appeals to the United States Court of Appeals for the Ninth Circuit from the final judgment entered in this action on the thirteenth (13th) day of December, 1968.

Dated: Feb. 7, 1969

CECIL F. POOLE
United States Attorney

By: John M. Youngquist
JOHN M. YOUNGQUIST
Assistant United States Attorney
Attorneys for Defendant.

UNITED STATES DISTRICT COURT FOR THE
NORTHERN DISTRICT OF CALIFORNIA

[*Caption Omitted*]

Civil No. 44353
Notice of Appeal

NOTICE is hereby given that the UNITED STATES OF AMERICA, defendant above named, hereby appeals to the United States Court of Appeals for the Ninth Circuit from the final judgment entered in this action on the thirteenth (13th) day of December, 1968.

Dated: Feb. 7, 1969

CECIL F. POOLE
United States Attorney

By: John M. Youngquist
JOHN M. YOUNGQUIST
Assistant United States Attorney
Attorneys for Defendant.

UNITED STATES DISTRICT COURT FOR THE
NORTHERN DISTRICT OF CALIFORNIA

[Caption Omitted]

Civil No. 44354
Notice of Appeal

NOTICE is hereby given that the UNITED STATES OF AMERICA, defendant above named, hereby appeals to the United States Court of Appeals for the Ninth Circuit from the final judgment entered in this action on the thirteenth (13th) day of December, 1968.

Dated: Feb. 7, 1969

CECIL F. POOLE
United States Attorney

By: John M. Youngquist
JOHN M. YOUNGQUIST
Assistant United States Attorney
Attorneys for Defendant.

UNITED STATES DISTRICT COURT FOR THE
NORTHERN DISTRICT OF CALIFORNIA

[*Caption Omitted*]

Civil No. 44355
Notice of Appeal

NOTICE is hereby given that the UNITED STATES OF AMERICA, defendant above named, hereby appeals to the United States Court of Appeals for the Ninth Circuit from the final judgment entered in this action on the thirteenth (13th) day of December, 1968.

Dated: Feb. 7, 1969

CECIL F. POOLE
United States Attorney

By: John M. Youngquist
JOHN M. YOUNGQUIST
Assistant United States Attorney
Attorneys for Defendant.

UNITED STATES DISTRICT COURT FOR THE
NORTHERN DISTRICT OF CALIFORNIA

[*Caption Omitted*]

Civil No. 44356
Notice of Appeal

NOTICE is hereby given that the UNITED STATES OF AMERICA, defendant above named, hereby appeals to the United States Court of Appeals for the Ninth Circuit from the final judgment entered in this action on the thirteenth (13th) day of December, 1968.

Dated: Feb. 7, 1969

CECIL F. POOLE
United States Attorney

By: John M. Youngquist
JOHN M. YOUNGQUIST
Assistant United States Attorney
Attorneys for Defendant.

UNITED STATES DISTRICT COURT FOR THE
NORTHERN DISTRICT OF CALIFORNIA

[*Caption Omitted*]

Civil No. 45575
Notice of Appeal

NOTICE is hereby given that the UNITED STATES OF AMERICA, defendant above named, hereby appeals to the United States Court of Appeals for the Ninth Circuit from the final judgment entered in this action on the thirteenth (13th) day of December, 1968.

Dated: Feb. 7, 1969

CECIL F. POOLE
United States Attorney

By: John M. Youngquist
JOHN M. YOUNGQUIST
Assistant United States Attorney
Attorneys for Defendant.

NOTATION RE OPINION AND JUDGMENTS OF COURT OF APPEALS

The opinion of the court of appeals, accompanied by an order amending the opinion, is printed in the Petition for Certiorari, and may be found therein at pages 31-42, as Appendix B. The judgments of the court of appeals are printed in the Petition for Certiorari, and may be found therein at pages 43-48, as Appendix C. They are therefore not reprinted in this Appendix.

SUPREME COURT OF THE UNITED STATES

No. 71-1022, October Term, 19

UNITED STATES,

PETITIONER

v.

JAMES A. BASYE, ET AL.

ORDER ALLOWING CERTIORARI. Filed April 3, 1972

The petition herein for a writ of certiorari to the United States Court of Appeals for the Ninth Circuit is granted.

☆ U.S. Government Printing Office: 1972—465-540/73

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In the Supreme Court of the United States

OCTOBER TERM, 1971

No. 71-

UNITED STATES OF AMERICA, PETITIONER

v.

JAMES A. BASYE AND EVELYN E. BASYE, ET AL.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

The Solicitor General, on behalf of the United States of America, petitions for a writ of certiorari to review the judgments of the United States Court of Appeals for the Ninth Circuit in these six cases, which were consolidated in the courts below and present the identical question.[1]

OPINIONS BELOW

The opinion of the district court (Appendix A, *infra*, pp. 15–29) is reported at 295 F. Supp. 1289. The opinion of the court of appeals (Appendix B, *infra*,, pp. 31–42, including an order amending the opinion) is reported at 450 F. 2d 109.

[1] The cases are combined in this petition pursuant to Rule 23(5) of the Rules of this Court. See *United States* v. *Mitchell*, 403 U.S. 190, 194.

JURISDICTION

The judgments of the court of appeals were entered on September 16, 1971 (Appendix C, *infra*, pp. 43–48). By order dated December 10, 1971, Mr. Justice Douglas extended the time for filing a petition for a writ of certiorari to and including February 12, 1972. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether compensation for services rendered by a medical partnership, and made payable by contract, and paid, to a trust, is income of the partnership, and therefore taxable to the partners, as the United States contends, or whether, as the courts below held, such compensation is not partnership income and will constitute income to beneficiaries of the trust, only when distributed to them.

STATUTES INVOLVED

The pertinent provisions of Sections 61, 401, 404, 701, 702, 703 and 704 of the Internal Revenue Code of 1954, are set forth in Appendix D, *infra*, pp. 49–51.

STATEMENT

Respondents are physicians and partners[2] in a

[2] "Respondents" refers collectively to James A. Basye, Carol L. Cook, Maurice C. Fishler, Henry Donald Grant, William S. Hunter, Jessamine S. Hunter, and Nadia Sorokowski, each of whom was a physician and partner during the years involved. Evelyn E. Basye, Jack J. Cook, Phyllis H. Fishler, Jean M. Grant, and George W. Sorokowski are parties to these actions only because they filed joint income tax returns with their respective spouses, and, in the case of Jean M. Grant for the year 1960, because she reported one-half of the community income in a separate return.

medical partnership, Permanente Medical Group ("Medical Group"), which was organized in 1949 to practice medicine in California. The partnership reports its income on the accrual basis. In 1960, it had over 200 physician-partners and 41 physician-employees. Under the partnership agreement, the partners had drawing accounts varying with responsibility and seniority, but were to share equally in net earnings in excess of the drawing accounts. (Appendix B, *infra*, pp. 31–32.)

In 1959, Medical Group entered into a detailed written agreement with Kaiser Foundation Health Plan, Inc. ("Health Plan"), an organization supplying prepaid medical care and hospital service to its members. Under the agreement, Medical Group agreed to furnish medical services to Health Plan's members in its Northern California Region, of whom there were then approximately 359,000. On its part, Health Plan agreed to make payments, as base compensation[1] to Medical Group for medical services, in two forms: (a) to pay Medical Group a stated amount (originally $2.61329, subject to adjustment) per month, per member, and (b) if Medical Group established a savings and retirement, or other deferred compensation, plan approved by Health Plan, to make the contributions required under that plan. (Appendix B, *infra*, p. 32.)

The plan in question was agreed upon and established by a trust agreement executed by Medical

[1] A provision for contingent additional compensation is not relevant to the issues in these cases.

Group, Health Plan, and a bank later in 1959, but effective from the date of the agreement. Under it, Health Plan made a payment of $200,000 to the trust at the outset, and agreed to make further payments on a per member, per month basis. The funds of the trust were to be used to pay retirement benefits to partners and physician-employees of Medical Group, computed on a complex of factors such as age, years of service, and compensation level. Tentative allocations of funds received were made under the plan, but were not vested prior to retirement, and might be lost prior to, or after, retirement by withdrawal from Medical Group for practice other than with another group serving Health Plan's members. The primary purpose of this feature of the agreement was to create an incentive for physicians to remain with Medical Group, and thus to insure Health Plan that it would have a stable and reliable group of physicians providing medical services to its members with a minimum of turnover. The trust was subject to amendment at any time by Health Plan and Medical Group. (Appendix B, *infra*, pp. 32–33).

Over a 3½-year period, Health Plan paid into the trust, on a monthly basis, an aggregate of more than $2 million. Medical Group did not include these payments in its partnership returns of taxable income, and they were not included in the partners' distributive shares of gross or taxable income. The Commissioner of Internal Revenue assessed deficiencies against the respondent partners for 1960

and 1961 on the ground that the compensation paid to the trust constituted gross income to the partnership, deflected to the trust through the contractual arrangement with Health Plan; and, therefore, that the partners were taxable on their distributive shares of such income. Respondents paid the taxes in dispute and, after their claims for refunds were denied, brought these suits for refund. (Appendix B, *infra*, p. 34.)

Both courts below held that the partnership realized no gross income from the payments because it never had a right to receive them, and further held that the partnership should be considered merely the agent of the partners, and should otherwise be disregarded in determining their tax liabilities. Treating the partners merely as contingent trust beneficiaries, the lower courts concluded that they would be taxable on payments to the trust only at such time as distributions were made by the trust. (Appendix A, *infra*, pp. 15–29; Appendix B, *infra*, pp. 31–42.)

REASONS FOR GRANTING THE WRIT

1. The decision below is in conflict with the holding in one of this Court's fundamental income tax decisions, *Lucas* v. *Earl*, 281 U.S. 111, a decision that is a principal bulwark of the graduated rate structure, and that this Court has subsequently described as embodying "the first principle of income taxation: that income must be taxed to him who earns it." *Commissioner* v. *Culbertson*, 337 U.S. 733, 739–740. The decision below is equally in conflict with

numerous decisions of courts of appeals following and applying *Lucas* v. *Earl*.[4]

When the court below permitted payments explicitly made as compensation for partnership services to be excluded from partnership income because of a contractual arrangement to deflect those payments to a trust, it acted in complete disregard of the historic statement of this Court that established "the first principle" of income taxation (281 U.S. at 114–115):

> There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.

The court below thought that *Lucas* v. *Earl* was not controlling because (Appendix B, *infra*, p. 39) "a crucial element * * * is missing here. Permanente never

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[4] *Allen* v *Commissioner*, 410 F. 2d 398 (C.A. 3), affirming 50 T.C. 466; *Hicks* v. *United States*, 314 F. 2d 180 (C.A. 4); *Megibow* v. *Commissioner*, 218 F. 2d 687 (C.A. 3); *Mayes* v. *United States*, 207 F. 2d 326 (C.A. 10); *Miller* v. *Commissioner*, 144 F. 2d 287 (C.A. 4); *Villere* v. *Commissioner*, 133 F. 2d 905 (C.A. 5); *Hogle* v. *Commissioner*, 132 F. 2d 66 (C.A. 10); *Comer* v. *Davis*, 107 F. 2d 355 (C.A. 5); *Jones* v. *Page*, 102 F. 2d 144 (C.A. 5); *Commissioner* v. *Bonwit*, 87 F. 2d 764 (C.A. 2), certiorari denied, 302 U.S. 694; *Canaday* v. *Guitteau*, 86 F. 2d 303 (C.A. 6); *Saenger* v. *Commissioner*, 69 F. 2d 631 (C.A. 5).

had the right itself to receive the payments made into the trust as current income." But much the same point was made by the same court when *Lucas* v. *Earl* was originally before it. See *Earl* v. *Commissioner*, 30 F. 2d 898, 899 (C.A. 9). In any event, the distinction is nonexistent. Since Mr. Earl had assigned half his income to his wife beginning in 1901, and *Lucas* v. *Earl* involved fees and salary earned in 1920 and 1921, he, also, "never had the right * * * to receive the payments." The same was true in the case of *United States* v. *Joliet & Chicago R. Co.*, 315 U.S. 44, and in the numerous courts of appeals cases following and applying *Lucas* v. *Earl*. See cases cited in note 4, *supra*. In all of these cases, the deflected income was held taxable to the person who earned it. Indeed, *Lucas* v. *Earl* would be no more than an empty admonition if a contractual arrangement to insulate a taxpayer from receipt of compensation he earned could serve to immunize him from taxation. And this Court's decision in *Helvering* v. *Eubank*, 311 U.S. 122, makes it clear that an attempted deflection of earned income is ineffective to avoid tax liability whether the deflecting arrangement is made before the income is earned, as in *Lucas* v. *Earl*, or after, as in *Helvering* v. *Eubank*.[5]

[5] The court of appeals' quotation (Appendix B, *infra*, p. 38) from *Helvering* v. *Horst*, 311 U.S. 112, with respect to "the diversion of income theory" is not entirely apposite. While *Horst* is, of course, a leading decision on the deflection of income, it dealt with the deflection of income from property, rather than from services. As pointed out in *Commissioner* v. *Sunnen*, 333 U.S. 591, taxation of deflected income from property turns upon ownership or control of the income-producing property, or control of the flow of income, while "[c]ompensa-

Nor does it alter the result that Health Plan's purposes were served by virtue of the deflection of partnership compensation to a trust. See *Commissioner* v. *LoBue*, 351 U.S. 243, 247; Section 61 of the Internal Revenue Code of 1954, Appendix D, *infra*, p. 49. Increased compensation paid with a view to reducing turnover and increasing stability in employment is not for that reason any the less taxable income. *Bingler* v. *Johnson*, 394 U.S. 741. As the Court explained in *Lucas* v. *Earl* (281 U.S. at 115), "the motives leading to the arrangement" permit no distinction. And though the agreement involved here is hardly consistent with the Ninth Circuit's conclusion (Appendix B, *infra*, p. 40) that "[t]he payments are to be viewed not as compensation for immediately past medical services but as compensation for the continued, long-term services of individual physicians," the payments to the trust would be includable in the partnership's income even if

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tion for personal services performed by the taxpayer is an inherently non-assignable gross income item." Lyon & Eustice, *Assignment of Income*, 17 Tax L. Rev. 295, 388 (1962). For a case in which decision turned upon whether the deflected income was from property or from services, see *Strauss* v. *Commissioner*, 168 F. 2d 441 (C.A. 2), certiorari denied, 335 U.S. 858, rehearing denied, 335 U.S. 888. However, even by *Horst* standards, there would be a basis for attributing to Medical Group the income paid to the trust, since the trust was subject to amendment by Medical Group and Health Plan, and, by statutory definition (Section 672 (a) and (b)), Health Plan was a nonadverse party. Under Sections 676 and 677 of the Code, a trust grantor may be taxed on trust income where, together with a nonadverse party, it has discretion (whether exercisable through amendment of the trust instrument or otherwise) to distribute trust income or principal to itself.

they were for future services. *Schlude* v. *Commissioner*, 372 U.S. 128; *Bingler* v. *Johnson*.

Because *Lucas* v. *Earl* is a cornerstone in the structure of the income tax law, no decision that impairs its integrity should be permitted to stand. The decision below does precisely this, and, for this reason alone, should be reviewed by this Court.

2. The decision below is in conflict also with the holding in a basic decision of this Court on the taxation of partnership income, *Heiner* v. *Mellon*, 304 U.S. 271, and with numerous decisions in the courts of appeals following and applying that decision.*

Since the enactment of Section II, D, of the Income Tax Act of 1913, c. 16, 38 Stat. 166, the federal statutes taxing income have treated partnership income in the manner that, in somewhat greater detail, is now set forth in Sections 701 through 704 of the Internal Revenue Code of 1954 (Appendix D, *infra*, p. 51): the partnership itself is not taxed, but it prepares and files a return in much the same manner that is required of an individual taxpayer, and the partners are required to take into income their distributive shares of partnership income. In *Heiner* v. *Mellon*, this Court held that distributive did not mean

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* *Starr* v. *Commissioner*, 267 F. 2d 148 (C.A. 7); *United States* v. *Baker*, 233 F. 2d 195 (C.A. 10); *Hulbert* v. *Commissioner*, 227 F. 2d 399 (C.A. 7); *Bell* v. *Commissioner*, 219 F. 2d 442 (C.A. 5); *Commissioner* v. *Goldberger's Estate*, 215 F. 2d 78 C.A. 3); *First Mechanics Bank* v. *Commissioner*, 91 F. 2d 275 (C.A. 3); *Bourne* v. *Commissioner*, 62 F. 2d 648 (C.A. 4), certiorari denied, 290 U.S. 650; see also *Beck Chemical Equipment Corp.* v. *Commissioner*, 27 T.C. 840; *deCousser* v. *Commissioner*, 16 T.C. 65; *Halkias* v. *Commissioner*, 12 T.C. 1091; *Freudmann* v. *Commissioner*, 10 T.C. 775.

distributable, and that partners are required to take into their individual income their distributive, or proportionate, shares of partnership income even though applicable state law prevents distribution. *A fortiori*, partners are required to take into their individual income their distributive shares of partnership income even though contractual or other consensual arrangements prevent distribution. See cases cited in note 6, *supra*.

It thus necessarily follows from the fact that Health Plan's payments to the trust constitute gross income to the partnership (see point 1, *supra*) that the respondent partners must take into their income their distributive shares of the partnership income despite any contractual arrangement, by trust or otherwise, to hold distribution in abeyance. Contrary to the court of appeals' understanding (Appendix B, *infra*, pp. 37, 41), the government's position that the payments constitute partnership gross income, and in consequence, gross income to the partners, does not turn on whether one follows the "entity" or "conduit" theory of partnerships. Those concepts can come into play only where there is a question of characterizing income, and there is, of course, no question that compensation for services is ordinary income to a partnership and to a partner. See Sections 61 and 702(a)(9). Under any theory of partnerships, therefore, the distributive shares of partnership income must be included in the income of the individual partners for the simple reason that the partnership earned the income. In disregarding this fact, in viewing the respondent partners only as contingent beneficiaries of the trust,

and in treating the partnership only as an agent to arrange contingent future compensation for the partners and physician-employees, the court of appeals erred. The Internal Revenue Code would command the result for which we contend here with respect to the partnership and the partners whether all, or only some, of the partners were potential beneficiaries of the trust, or whether the potential beneficiaries were children or other relatives of the partners.

Likewise mistaken is the court of appeals' conclusion (Appendix B, *infra*, p. 36) that had respondents "contracted individually with * * * [Health Plan] for payments into a retirement trust subject to the same conditions involved here, they would not be subject to taxation in the years the payments were made." Under *Lucas* v. *Earl*, an individual physician (or, for that matter, a corporation) contracting with Health Plan, with similar provisions for payments to a trust for himself and his employees, or for others, would be taxed currently on amounts irrevocably paid to the trust because, as to him, such payments would be no more than deflected compensation for services rendered. The cases upon which the court below relied (see Appendix B, *infra*, p. 36) would be relevant, irrespective of whether an individual, a corporation, or a partnership contracted with Health Plan, only if the government asserted deficiencies against the employee-beneficiaries of the trust who might never be compensated for their services. They are of no relevance where, as here, the contracting party (the partnership) was irrevocably compensated by the bargained-for payments to the trust, and we are concerned only

with the tax liabilities of the individual partners therefor.

3. The decision below effectively circumvents the limitations upon qualified pension trusts established by Section 401 of the Internal Revenue Code of 1954, Appendix D, *infra*, pp. 49–50.

Section 401, as effective during the years in controversy, establishes for qualified pension trusts the terms upon which the Congress has sanctioned deferred compensation plans with the tax benefits of current deductibility to the employer and deferred taxation of the employee. Among other conditions, such a trust must be "for the exclusive benefit of * * * employees or their beneficiaries." Section 401 (a). Moreover, such a trust must not discriminate in favor of officers, supervisory employees, or highly compensated employees. Section 401(a)(4). Because of these conditions, there could be no qualified pension trust for the benefit of self-employed individuals, whether partners or sole proprietors, during 1960 and 1961. Though that restriction has been relaxed somewhat in later years by amendments to the Code effected by the Self-Employed Individuals Tax Retirement Act of 1962, P.L. 87–792, 76 Stat. 809, the conditions imposed even under the relaxed provisions remain rigorous, both as to discrimination in favor of highly compensated individuals, and as to amounts that may be contributed to a pension trust for the benefit of partners rather than employees.

The trust here involved, which was principally for the benefit of partners, and otherwise provided benefits only for professional physician-em-

ployees, could not qualify under either the standards of 1960 and 1961 or those of later years. Yet, in frustration of the statutory limitations on qualified pension trusts, the decision below produces for the partnership and the partners the principal tax benefits of such a trust, and thus openly invites partnerships to circumvent the requirements carefully devised by Congress as conditions to obtaining these benefits.[7] Under the decision, there is nothing to prevent partnerships, large and small, and in any business or profession, from establishing similar plans to avoid tax on whatever portion of their compensation they choose to defer.

4. Apart from the mischief the decision below is certain to cause within the Ninth Circuit, and may cause elsewhere, the instant cases are of immediate administrative importance. We are advised by the Internal Revenue Service that the cases of 568 taxpayers (many involving several taxable years) in California and Oregon are being held open pending final disposition of the instant cases. The tax deficiencies in the open cases aggregate more than $1.6 million, and the statutory interest on these deficiencies, which relate to 1962 and earlier years, brings the total amount in dispute to approximately $2.5 million.

[7] If the trust had constituted a pension trust for employees qualified under Section 401, the payments to the trust by Health Plan would still have constituted gross income to the Medical Group partnership but would, at the same time, have given rise to an offsetting deduction by Medical Group. However, since on several grounds, including the fact that it was principally for the benefit of partners, the trust was not a qualified pension trust under Section 401, the offsetting deduction would be denied by Section 404, Appendix D, *infra*, p. 50.

456-467—72——3

CONCLUSION

The court below has on two scores unsettled what was settled by this Court more than thirty years ago. Review and correction is therefore appropriate.

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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FEBRUARY 1972.

APPENDIX A

In the United States District Court for the Northern District of California

Consolidated Actions

Civil No. 44352

JAMES A. BASYE AND EVELYN E. BASYE, PLAINTIFFS

v.

UNITED STATES OF AMERICA, DEFENDANT

Civil No. 44353

JACK J. COOK AND CAROL L. COOK, PLAINTIFFS

v.

UNITED STATES OF AMERICA, DEFENDANT

Civil No. 44354

MAURICE C. FISHLER AND PHYLLIS H. FISHLER, PLAINTIFFS

v.

UNITED STATES OF AMERICA, DEFENDANT

Civil No. 44355

HENRY DONALD GRANT AND JEAN H. GRANT, PLAINTIFFS

v.

UNITED STATES OF AMERICA, DEFENDANT

Civil No. 44356

WILLIAM S. HUNTER AND JESSAMINE S. HUNTER, PLAINTIFFS

v.

UNITED STATES OF AMERICA, DEFENDANT

Civil No. 45575

GEORGE W. SOROKOWSKI AND NADIA SOROKOWSKI, PLAINTIFFS

v.

UNITED STATES OF AMERICA, DEFENDANT

Memorandum and Order Directing Judgment for Plaintiffs

These are consolidated actions for the refund of income taxes, and each one poses the identical problem which arises within the partnership provisions of the Internal Revenue Code. The facts have been stipulated to by the taxpayer petitioners and the respondent Commissioner of Internal Revenue. The petitioners are physicians who were each, during the years involved in their respective cases, general partners in a limited partnership of physicians organized in 1949 to practice medicine in California under the name of "The Permanente Medical Group" (hereinafter referred to as Permanente or as the partnership). This partnership used the accrual method of tax accounting in filing its partnership information returns. All partners used the cash method of accounting.

Prior to the years involved in these cases, Permanente contracted with Kaiser Foundation Health Plan, Inc. (hereafter referred to as Kaiser), a California nonprofit corporation, to provide medical services to members of Kaiser in its Northern California Region. Kaiser operates a contractual membership program providing pre-paid hospital and medical care to its dues paying members. The contract provided that Kaiser would not only pay a basic compensation to Permanente for the medical services, but would also make payments toward a retirement plan when such a plan was approved by Kaiser. On or about December 30, 1958, such a plan (hereafter referred to as the Retirement Plan) was established to take effect as of July 1, 1959, by a trust agreement among Kaiser, Permanente, and the Bank of America National Trust and Savings Association, as trustee. In entering into both the original medical services contract and the trust agreement, Permanente and Kaiser were and remained independent organizations contracting at arms length.

The primary purpose of the trust agreement and the retirement plan is to create an incentive for physicians to remain with Permanente, or if they left Permanente, then to join some other group of physicians contracting to serve Kaiser members, thereby ensuring Kaiser that it would have a stable and reliable pool of physicians providing medical services to its members. To secure this purpose, the Retirement Plan contains the following provisions. A trust fund under the Bank of America trusteeship was established, and is to be supported by payments from Kaiser in partial compensation for the services of Permanente. Each physician who had served two years within Permanente, both those who were partners and those who were merely employees, was assigned a certain number of "units", which took into account such factors as the physician's salary from Permanente, his past service with Permanente, and the age at which he became associated with Permanente. Tentative accounts were then set up for each physician, and these accounts were credited with portions of the trust fund earnings (which included payments from Kaiser plus interest accrued on the corpus), with each account receiving credits in proportion to the units assigned to that particular physician. The accounts are tentative because the eventual enjoyment by any physician of his accrued share of the fund depends on several contingencies. If either a partner-participant or an employee-participant in the Retirement Plan terminates his affiliation with Permanente, for reasons other than his death or disability, prior to reaching age 65 or serving Permanente for fifteen continuous years, and if the participant does not thereupon join another medical group serving Kaiser subscribers, he forfeits the amounts allocated to his tentative account. And even upon his becoming eligible to receive retire-

ment benefits from his tentative account, a participant may lose his right to these benefits if he renders professional services for a competitor of Kaiser, or if, while he is physically fit and legally entitled to practice medicine, he refuses to render consulting services to any medical group under contract with Kaiser, when reasonably requested to do so. Moreover, a "Retirement Committee", composed of representatives selected by both Kaiser and Permanente, is given the power to prescribe further conditions to the receipt of Retirement Plan benefits by participants.

The effect on each participant's rights in the trust fund in the event of a dissolution or reorganization of Permanente is of particular interest in the present case. The trust agreement provides that if, in the event of a dissolution or reorganization of Permanente, at least 50% of the combined total of practicing partner-participants and employee-participants become reassociated with a reorganized Permanente or with another group serving Kaiser subscribers, then the trust fund shall be kept intact and any unretired physician-participant who does not join in the new grouping shall forfeit his rights in the trust fund. The forfeiture will not occur in either of two circumstances. First, if in connection with Permanente's dissolution or reorganization, Kaiser and Permanente jointly agree to use the trust funds to support a new retirement plan which they believe will provide better retirement benefits for the participants, or will better effect the original purpose of the trust agreement (viz., a reliable pool of doctors for Kaiser), then such a new retirement plan could provide that the accruals in the tentative accounts of all participants would be preserved. Second, if there is a dissolution or reorganization of Permanente without the above-mentioned 50% regrouping and without the creation of a new

retirement plan by Permanente and Kaiser, then the assets held by the trust fund are to be liquidated and the proceeds distributed to all participants, retired and active, in lump sums prorated according to the tentative account balances.

The Commissioner of Internal Revenue determined that the partnership income returns filed by Permanente for its fiscal years ending June 30, 1960 through 1963 had understated income in omitting the sums of Kaiser's payments to the trust fund and the earnings on trust corpus. The Commissioner further determined that the increased partnership income was taxable to the partners for each calendar year in which the partnership fiscal year ended, and he assessed deficiencies in the individual income tax returns of each of the partners, including plaintiffs. In computing the deficiency for each partner, the Commissioner used the following formula. He calculated the total sum of payments attributable to the tentative accounts of *employee*-participants in the Retirement Plan, and he assessed each partner for these payments according to that partner's distributive share of general partnership income under the partnership articles.[1] He further assessed each partner for the annual increments in trust earnings attributable to that partner's own tentative account in the Retirement Plan, thereby treating the "unit" allocations under the trust agreement as a modification of the basic partnership agreement on the distribution of partnership earnings.[2]

[1] See Int. Rev. Code of 1954, § 704(b). The theory underlying this aspect of the assessment was probably that Health Plan by funding the retirement plan for the employee-physicians was saving Permanente from incurring the expense for such a project, and was therefore in effect supplying Permanente with additional income.

[2] See Int. Rev. Code of 1954, § 704(a), and Reg. 1.761-(c).

It is this latter assessment which is contested here. Plaintiffs do not contend that they should never be taxed on the allocations to their tentative accounts, but rather that, in view of the many contingencies which condition their actual receipt of the proceeds represented in their accounts, the tax should be postponed until such actual receipt. The government prefers to tax the plaintiffs immediately, and to deal with subsequent forfeitures of rights to trust fund proceeds by allowing a loss deduction to a partner in the year of his forfeiture, and equivalent to the total tentative accruals forfeited. The remaining partners would then be taxed on the pro rata increases in their tentative accounts resulting from the liquidation of the forfeiting partner's account.[3]

The government and the plaintiffs have waged their battle on three separate legal fronts. For the reasons set out below, this Court finds that plaintiffs have prevailed in all three sectors.

I

One ground upon which the government seeks to uphold its action is by analogizing the facts here to those in *Lucas* v. *Earl*, 281 U.S. 111. In that case the Supreme Court refused to allow a husband to escape

[3] One of the plaintiffs here, Dr. Nadia Sorokowski, terminated her membership in the partnership in 1963, thereby forfeiting her rights to receive any payments from the trust. In 1966 the Commissioner on his own initiative, determined that Dr. Sorokowski was entitled to an ordinary loss deduction which would offset the assessment of trust income made against her, and the Commissioner made a further assessment against the remaining partners according to their pro rata tentative shares of Dr. Sorokowski's terminated account. Dr. Sorokowski has refused to accept the refund and stands with the other plaintiffs in contesting the Commissioner's deficiency assessments.

taxes on one-half of his income by having assigned one-half of it to his wife as a joint tenant. The Court declared that tax on a salary could not be avoided by the person earning the salary by anticipatory arrangements and contracts. The government here contends that it is the partnership which is earning the payments by Kaiser into the trust fund, and that, following *Lucas* v. *Earl*, the partnership (and hence the physician-partners *qua* partners) should not be allowed to escape immediate taxation through the assignment of the ultimate receipt of the payments to the partners *qua* individual trust fund participants. The government's contention has some persuasive force, but it ignores several lower court decisions which have persuasively refused to find *Lucas* v. *Earl* applicable in cases where a taxpayer confers the right to receive income upon another individual, but the taxpayer, while having earned the income, would never have had the right to himself receive it.[4] In

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[4] In *Commissioner* v. *Giannini*, 129 F. 2d 638 (9th Cir. 1942), the president of a bank refused without qualification his salary for the year 1927, offering a precatory suggestion that the money be used for some worthwhile purpose. The Commissioner argued, citing *Lucas* v. *Earl*, that "a taxpayer realizes 'income' when he directs the disposition thereof in a manner so that it reaches the objects of his bounty; * * *" 129 F. 2d at 640. The Ninth Circuit affirmed the decision of the Board of Tax Appeals that this money was not income to the taxpayer, because "the taxpayer did not receive the money, and * * * did not direct its disposition." 129 F. 2d at 641. In deciding the instant case, one cannot derive sufficient precedential force from *Giannini* alone, because Permanente *did* direct, as a co-party to the trust agreement, the disposition of the payments by Kaiser. Yet it should be noted that the present case calls more for a distinction from *Lucas* v. *Earl* than did *Giannini*, as regards the matter of initial right to receive the income involved. The taxpayer in *Giannini* had that right; Permanente never did.

Paul A. Teschner, 38 T.C. 1003, the taxpayer entered a contest in which the prize was an annuity policy to be used for college expenses. Only persons under seventeen were eligible to receive the prize, and any contest entrant over that age had to designate someone under seventeen to be the recipient. The taxpayer had designated his daughter as a recipient, and he won the contest. The Tax Court rebuffed the Commissioner's attempt to treat the prize as income of the taxpayer. In response to the Commissioner's assertion that "The basic rule in determining to whom an item of income is taxable is that income is taxable to the one who earns it * * *", the Court replied:

> If by this statement the [Commissioner] means that income is in all events includible in the gross income of whomsoever generates or creates the income by virtue of his own effort, the respondent is wrong. If this were the law, agents, conduits, fiduciaries, and others in a similar capacity would be personally taxable on the proceeds of their efforts. The charity fund-raiser would be taxable on sums contributed as the result of his efforts. The employee would be taxable on income generated for his employer by his efforts. Such results, completely at variance with every accepted concept of Federal income taxation, demonstrate the fallacy of the premise. 38 T.C. at 1007.

It must be noted that the Court reached its result despite the fact that the taxpayer's choice of a recipient relieved him of a later probable expense, that is, his daughter's college education. There is no evidence of such an effect in the present case.

Another case which is very much in point is *Nicholas A. Stavroudis*, 27 T.C. 583. The taxpayer was the beneficiary of a trust established in part with her own property and according to an agreement with the settlor. Under the terms of the trust, if the income from

the trust property exceeded an amount necessary to make the taxpayer's total income for that year equal to $25,000, then one-third of such excess was to be paid to the taxpayer, and the taxpayer had the power to appoint the remaining two-thirds to such of the settlor's children as the taxpayer chose. If the taxpayer failed to dispose of this two-thirds excess within 30 days after the close of the year, the undisposed portion would be added to the principal of the trust property. On these facts, the tax court held that the two-thirds excess income from a given year was not taxable to the taxpayer. This holding was made despite the court's acknowledgment of the fact that it was within the taxpayer's power, by a failure to appoint the two-thirds excess to any of the children, to increase the trust corpus and thereby derive a benefit to herself through her one-third interest in excess trust income. While the court in *Stavroudis* limited its discussion to the separate Code provisions and caselaw dealing with the tax treatment of trust income, a principle analogous to that in *Lucas* v. *Earl* also applies in this area and guides judicial decisions, see *Harrison* v. *Schaffner*, 312 U.S. 579, and *Stavroudis* is thus instructive in the disposition of the instant case.

This Court concludes, in the light of the above cases, that *Lucas* v. *Earl* does not require characterization of the payments to the trust fund as income of the partnership, with a resulting justification of the immediate taxation of the partners on their tentative shares of these payments. Instead, one can examine the nature of the payments vis-a-vis the partners, as if they had directly bargained with Kaiser for these payments. Viewed in this manner, the payments do not justify an immediate tax upon the partners, because the eventual enjoyment of these payments is

subject to the many contingencies established in the trust agreement. Arrangements similar to the Retirement Plan here have been held not to result in the realization of taxable income in the year in which employer contributions to a pension trust were made, where the employee taxpayer accounted for his income, as do the petitioners here, on a cash receipts basis. See *Julian Robertson*, 6 T.C. 1060, *acq.*, 1946 — 2 Cum. Bul. 4, and *Harold G. Perkins*, 8 T.C. 1051, *acq.*, 1947 — 2 Cum. Bul. 3.

Even if petitioners used the accrual method for computing their taxable income, immediate taxation would not be justified.[4] The regulations of the Internal Revenue Service provide: "Generally, under the accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." Reg. 1.446-1(c)(ii). As to the effect of contingencies in computing the income of an accrual method taxpayer, Mertens states: "Income does not accrue to a taxpayer until there arises in him a fixed and unconditional right to receive the amount * * *. If there are substantial contingencies as to the taxpayer's right to receive or uncertainty as to the amount he is to receive, an item of income should not be accrued until the contingency or events have occurred and fixed the fact and amount of the sum involved. 2 Mertens, *Law of Federal Income Taxation* § 12.60, p. 209.

In *North American Oil Consolidated* v. *Burnet*, 286 U.S. 417, the Supreme Court rejected the notion that someone can be taxed on something which might never be received. In that case, the taxpayer was engaged

[4] "A fortiori, what is contingent income for an accrual basis taxpayer would also be contingent for taxpayers, such as the petitioners, who employ the cash method of tax accounting."

in litigation over the ownership of certain income-producing property, and the income from the property for 1916 was held by a court-appointed receiver pending the outcome of the litigation, and paid to the taxpayer in 1917. The taxpayer contended that the income was realized in 1916, and accordingly reported the income on its 1916 return. The government, however, contended that it was not realized until 1917, and the Court agreed:

> The net profits were not taxable to the company as income for 1916. For the company was not required in 1916 to report as income an amount which it might never receive [citations] * * *. [A]t no time during the year was there a right in the company to demand that the receiver pay over the money * * *. Nor is it material, for purposes of this case, whether the company's return was filed on the cash receipts and disbursements basis, or on the accrual basis. In neither event was it taxable in 1916 on income which it had not yet received and which it might never receive. 286 U.S. at 423.

In *Guarantee Title & Trust Co.* v. *C.I.R.*, 313 F. 2d 225 (9th Cir., 1963), the taxpayer corporation was in the business of servicing mortgage debts, and it had a contract with a bank whereby it got a fixed periodic payment from the bank for its services on mortgages, with a possibility of additional payments if certain contingencies occurred, such as prepayment of the loans. These additional payments would be made to the taxpayer according to a schedule, and were designed to compensate it in cases where premature satisfaction of a debt relieved the bank of the need for the taxpayer's services. The taxpayer, which kept its books on an accrual basis, established a bookkeeping account in which it accrued the pro rata amount of additional payments which it would receive as per the schedule if and when a given debt was satisfied

prematurely. The court held that the taxpayer needn't pay income tax on the amounts accrued in this account at the time of their accrual, because the eventual receipt of such amounts was too contingent. See also *Etheridge and Vanneman, Inc.* v. *C.I.R.*, 40 T.C. 461.

Long Poultry Farms v. *C.I.R.*, 249 F. 2d 726 (4th Cir. 1957), dealt with the taxability of a member of a tax-exempt agricultural cooperative on reserves held by the cooperative. A certificate was issued to the member in an amount representing his share of these reserves. The government contended that the amount represented by the certificate should be included in the member's proportionate share of the cooperative's income for tax purposes. While the specific sum represented by the certificate was credited to the member's tentative account, the cash redemption of the certificate was subject to several conditions, such as the making of a profit by the cooperative, and it could not be sold. The court held that the member, who was on an accrual accounting basis, could not be taxed on the amount represented by the certificate.

> To require the inclusion in income of contingent credits such as are here involved, would be to require the [members] of cooperatives to pay tax upon income which they have not received, over which they have been given no control and which they may never receive. Apart from the question of constitutionality of such a requirement, which would be a serious one, it is a safe assumption that Congress never intended to impose * * * the hardship and burden which the taxability of these contingent credits would involve. 249 F. 2d at 731.

II

Even if *Lucas* v. *Earl* were flatly applied here so that the payments by Health Plan into the trust were

regarded as being made to the partnership, a straightforward application of the long-standing principles regarding tax treatment of partnerships and partners would still require that we focus on the contingent nature of the rights which the individual partners have in the trust fund. The Code provisions dealing with partnership taxation call for application of what has come to be called the conduit approach. Section 702(b) provides:

> (b) Character of Items Constituting Distributive Share.—The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share [of partnership earnings] shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.

In characterizing the nature of a partner's distributive share of partnership earnings under this approach, one must conceptually remove the partnership from the flow of the particular earnings, and imagine that a given partner as an individual will be the direct recipient of whatever earnings there are. From this viewpoint, one must ask what would be the taxable nature of the earnings in that partner's hands. See Senate Finance Committee Report, 3 U.S. Code Cong. & Admv. News, 83rd Cong., 2d Sess., p. 4722; 6 Mertens, *Law of Federal Income Taxation*, § 35.22, p. 63; and cf. Reg. 1.702–1(a)(8).

Applying the conduit approach to the present case, it is apparent that the cases dealing with the tax treatment of contingent earnings are once again applicable, and again the same result is reached with regard to the petitioners.[4]

[4] An interesting question arises, however, as to whether two of the cases cited above, *Perkins* and *Robertson*, would be relevant under this second analysis which flatly applies *Lucas* v. *Earl* and regards the partnership as being the "recipient" of the

III

The government has attempted to support its actions here by focusing on the trust arrangement involved. The government first argues that since Kaiser can never get back any of its contributions, the trust lies irrevocably in favor of Permanente and therefore Permanente through the partners should be immediately taxed on all accretions. The argument ignores the fact that the trust lies in favor of the *participants*, which includes mere employees of the partnership, and that it is possible under the terms of the trust agreement for all partner-participants to forfeit their rights in the trust and leave only the employees as beneficiaries.

The government also argues that Permanente is a co-grantor of the trust and that Permanente through its partners had the power to revest title to the trust in itself and distribute the proceeds, so that the government's action is justified under § 676 of the Code[1] and *Corliss* v. *Bowers*, 281 U.S. 376. But Permanente does not have this power. Under the trust agreement,

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payments. *Perkins* and *Robertson* involved taxpayers who used the cash method of accounting, and the courts in those cases deferred taxation on the basis of the constructive receipt doctrine. But when a partnership is present the rule is that a cash method partner must return his distributive share of income accruing to an accrual method partnership as that income accrues. *Appeal of Truman*, 3 B.T.A. 886 (1926), *Truman* v. *United States*, 4 F. Supp. 447 (N.D. Ill. 1933). The other contingent earnings cases discussed above involved accrual method taxpayers and would therefore be applicable even under the conduit analysis.

[1] Sec. 676. Power to Revoke. (a) *General Rule.*—The grantor shall be treated as the owner of a trust, whether or not he is treated as such owner under any other provision of this part, where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a nonadverse party, or both.

if a majority of the present number of partners (e.g. 110 out of 200) decided to terminate their contract with Kaiser and to discontinue serving Kaiser members, they would forfeit their rights in the retirement plan if 50% or more of the *participants* (e.g. the remaining 90 partners and the 40 employee-doctors) chose to continue serving Kaiser members. While the agreement provides that the partnership may replace the present trust with a trust having different terms, Permanente cannot do this without the joint agreement of Kaiser.

The government seeks to impute a termination power to Permanente because Permanente selects four out of the seven members of the Retirement Committee established in the trust agreement. But the Committee's power is limited to establishing and enforcing conditions which retired participants must satisfy in order to receive trust benefits, and also offering advice to the trustee on trust administration problems.

This Court thus concludes that the petitioners, and the other partners of Permanente, cannot be taxed now on the trust earnings attributed to their individual accounts, but that taxation must be postponed until the partner begins receiving benefits.

Accordingly judgment shall be for plaintiffs in each of the consolidated actions.

This opinion shall serve as findings of fact and conclusions of law in each of the consolidated actions under Rule 52(a). Plaintiff's counsel shall submit judgments in accordance with above memorandum opinion.

Dated: November 29 1968.

S/ ALBERT C. WOLLENBERG,
United States District Judge.

APPENDIX B

United States Court of Appeals for the Ninth Court

No. 24,170–75

September 16, 1971

JAMES A. BASYE AND EVELYN E. BASYE,
PLAINTIFFS-APPELLEES

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

Appeal from the United States District Court for the Northern District of California

Before: MERRILL, DUNIWAY and HUFSTEDLER, *Circuit Judges.*

DUNIWAY, *Circuit Judge:*

Appellee taxpayers brought these consolidated actions in the District Court for the refund of income taxes paid for the taxable years 1960 through 1963. The District Court found in their favor, 295 F. Supp. 1289, and the government appeals. We affirm.

The case was submitted to the district court on the parties' agreed statement of facts. Taxpayers are physicians who, during each of the tax years involved, were general partners in the Permanente Medical Group (Permanente), a limited partnership organized in 1949 to practice medicine in California. The Articles of Partnership provide that "all earnings by any of the partners from the practice of medicine * * * shall belong to the partnership," and that each partner's "compensation shall be restricted to his distributive portion of the earnings of the partnership."

Permanente reported its income by the accrual method in the information returns that it filed for the years involved in these cases; appellees reported their individual income by the cash method.

Before the tax years in question, Permanente contracted with Kaiser Foundation Health Plan, Inc. (Kaiser) to provide medical services to members of Kaiser in its Northern California region. Kaiser operates a pre-paid hospital and medical care program for its dues paying members. The contract between Permanente and Kaiser provides for exclusivity of service—Kaiser agrees not to contract with other physicians for medical services and Permanente agrees not to render such services to other direct service, prepayment plans. Under the contract Kaiser pays Permanente as compensation for the services of its physicians a monthly sum based on the size of Kaiser's membership. In addition the contract contemplates the creation of a retirement plan to which Kaiser would make additional payments. Such a plan was established to take effect July 1, 1959, by a trust agreement between Kaiser, Permanente and Bank of America National Trust and Savings Association, as trustee. This retirement plan is the focal point of the tax controversy.

The primary purpose of the retirement plan is to insure Kaiser a stable and reliable pool of physicians providing medical service to its members. The plan accomplishes this purpose by creating an incentive for physicians to devote their careers to Kaiser members, either by remaining with Permanente or by joining some other group of physicians contracting to serve Kaiser members. The plan operates in the following manner. Kaiser makes payments into the trust each month as partial compensation for the services of Permanente. Any physician with a minimum of two years

service in Permanente, whether or not a partner, is eligible to participate in the plan. Each participant is assigned a certain number of "units" based on such factors as his salary, his past service with Permanente and his age at the time of his association with Permanente. The earnings of the trust fund (payments by Kaiser plus interest accrued on corpus) are tentatively credited to each participant's account in proportion to his assigned number of units.

When a participant retires, the total amount allocated to his account is used to purchase a retirement annuity contract. Until then, however, his account remains merely "tentative" because the amount allocated to it may change or his right to receive it at all may be defeated by the occurrence of one or more specified contingencies. First, if a participant in the plan leaves Permanente for reasons other than death or disability before either age 65 or the completion of fifteen years continuous service, and does not thereafter join another medical group serving Kaiser members, he forfeits all rights to the amount allocated to his tentative account. In the case of forfeiture, the amount forfeited is reallocated among the accounts of the remaining participants; none is ever repaid to Kaiser. Second, a participant will forfeit his right to the accrued benefits even after he has become eligible to receive them if he renders professional services for a competitor of Kaiser or if, while able to do so, he refuses to render consulting services to Kaiser or its affiliates. Third, if Permanente is dissolved or reorganized, and if at least 50% of the participants in the retirement plan reassociate with the reorganized Permanente or with another group serving Kaiser members, the trust fund remains intact and unretired participants who do not join the new group forfeit their accrued benefits. The forfeiture will not occur in two circumstances: (a) by mutual agreement Kaiser

and Permanente could use the trust funds to support a new retirement plan which would preserve the accruals of all participants; (b) in the case of dissolution or reorganization without the 50% regrouping, the trust fund is to be liquidated and the proceeds distributed *pro rata* to all participants.

During the four tax years involved Kaiser paid into the trust fund a total amount in excess of $2 million. Net earnings on the corpus amounted to an additional $60 thousand. Permanente did not report these amounts in its partnership income returns, nor did the partners include them in their individual returns. The Commissioner of Internal Revenue determined that the omission of these sums resulted in an understatement of partnership income and in deficiencies in the income tax returns of each of the partners. In computing the deficiencies, the Commissioner calculated the total amount of trust earnings attributable to employees' accounts in the retirement plan, and allocated this sum among the partners according to their distributive shares of partnership income. The theory of this assessment, apparently, is that the payments into the plan by Kaiser in favor of employees of Permanente relieved the partnership of an expense that it might otherwise have undertaken and thus created additional income. This part of the Commissioner's determination is not now contested. With regard to each partner's own tentative account in the retirement plan, the Commissioner treated the "unit" allocations as a modification of the distribution provisions in the partnership agreement and assessed each partner for the annual increment attributable to his own account. The latter assessment is the one in dispute here.[1]

[1] The district court's decision that the interest on the trust corpus is taxable to the trust is not contested on this appeal.

The taxpayers do not contend that the payments into the trust by Kaiser should never be taxed, but they do disagree with the Commissioner as to *when* the tax ought to be imposed and upon *whom*. Because of the substantial possibility of forfeiture of the right to receive the amounts allocated to the tentative accounts,[2] taxpayers argue, there is no current realization of income to the individual partners and taxation should be postponed until the right of receipt has become fixed. The government, on the other hand, prefers to tax now and to treat the amount on which the tax is paid as an addition to each partner's basis in his respective partnership share. Should a partner subsequently forfeit the amount in his tentative account, he would get a capital loss for that which was taxed earlier as ordinary income.[3]

This case thus presents the question whether the payments by Kaiser into the retirement trust were income realized by the taxpayers in the years in which the payments were made. We hold first that, viewing the taxpayers solely in their individual capacities as participants in the retirement plan, there is no current realization of taxable income. The amounts allocated to the tentative accounts are completely contingent and forfeitable; when payments are made to the trust, it is not possible to determine just who among the participants will ever receive the amount

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[2] During the years 1960–1963, twenty-three physicians forfeited tentative accounts totaling in excess of $60 thousand.

[3] In the trial court, the government took the position that a forfeiture gave rise to an ordinary loss deduction in the year of forfeiture equal to the entire amount of tentative accruals on which the tax had been paid in earlier years. Each remaining participant then had ordinary income in the amount his account was augmented by the forfeiture. Perhaps recognizing the bureaucratic nightmare thus created, the government has now changed its position.

in his tentative account or by how much his account will have been augmented by forfeitures of other participants at the time of receipt. Taxpayers have not constructively received the amounts allocated to their tentative accounts, because they have never had a right to immediate receipt of the payments and they have exercised no control over their disposition. The payments were made solely to fund the trust. Had a participant elected not to join the plan, he could not have received his allocable share as current income in lieu of payments into the trust. Finally, because the tentative accounts cannot be transferred or assigned and are completely forfeitable, the payments into the trust confer no immediate economic benefit upon the participants. *Cf. Commissioner* v. *LoBue*, 1956, 351 U.S. 243, 249.

For these reasons we conclude that had the taxpayers contracted individually with Kaiser for payments into a retirement trust subject to the same conditions involved here, they would not be subject to taxation in the years the payments were made. This conclusion accords with the decisions of both the courts and the Internal Revenue Service holding that payments made into deferred compensation plans which include substantial forfeiture provisions are not taxable until actually received or otherwise made available to the taxpayer, even though not qualifying for special treatment under §§ 401–404 of the Internal Revenue Code. See *Drysdale* v. *C.I.R.*, 6 Cir., 1960, 277 F.2d 413; *Schaefer* v. *Bowers*, 2 Cir., 1931, 50 F.2d 689; *Harold G. Perkins*, 1947, 8 T.C. 1051; *Julian Robertson*, 1946, 6 T.C. 1960; Rev. Rul. 67–449, 1967–2 Cum. Bull. 173.[4]

[4] Some of the authorities cited antedate the deferred compensation provisions of the 1954 Code. Nevertheless, the same realization rules apply to a post-1954, non-qualifying plan as apply to a pre-1954 plan.

The government does not contend that those cases were incorrectly decided but argues instead that because the taxpayers here chose to do business as partners rather than as individuals, the tax result is different. A partnership as such is not subject to the income tax. Int. Rev. Code of 1954, § 701. A partnership is required to report its income, however, and the partners are separately taxable upon their distributive share of partnership net income whether or not such share was actually distributed to them. Int. Rev. Code of 1954, § 702(a); Treas. Reg. § 1.702–1(a) (1956); *Heiner* v. *Mellon*, 1938, 304 U.S. 271, 281. The government argues that the payments into the retirement trust were undistributed partnership income and are thus taxable to each partner according to his proportionate share represented by his tentative account allocation.

The government's argument really involves two steps. First, the government argues, taxability of partnership income is to be determined at the partnership level (the "entity" approach). The taxpayers counter by arguing that taxability of partnership income is to be determined by ignoring the partnership and treating the individual partners as if they had engaged directly in the transaction in question (the "conduit" approach).[4] We assume, without deciding, that taxability is determined at the partnership level. But there

[4] The district court adopted the "conduit" approach. Because we hold that neither the partnership as an entity nor the partners as individuals realized taxable income, we find it unnecessary to choose between the "entity" and "conduit" approaches, and this opinion is not to be read as adopting either of them. For a discussion of the general problem of characterization of partnership income see Wolfman, *Level for Determining Character of Partnership Income—"Entity" v. "Conduit" Principle in Partnership Taxation*, 19 N.Y.U. Institute on Federal Taxation 287 (1961).

is a second step to the government's argument: the partnership has realized taxable income. We hold that in this case it has not.

Section 703(a) of the Code, in relevant part, provides that "[t]he taxable income of a partnership shall be computed in the same manner as in the case of an individual * * *." Thus we apply the same realization rules to the partnership that we would apply to an individual. During oral argument, government counsel, citing *Lucas* v. *Earl*, 1930, 281 U.S. 111, and *Hulbert* v. *C.I.R.*, 7 Cir., 1955, 227 F. 2d 399, relied principally upon a diversion of income theory. The Supreme Court in *Helvering* v. *Horst*, 1940, 311 U.S. 112, explained the diversion of income theory as follows:

> "[T]he rule that income is not taxable until realized has never been taken to mean that the taxpayer, even on the cash receipts basis, who has fully enjoyed the benefit of the economic gain represented by his right to receive income, can escape taxation because he has not himself received payment of it from his obligor. * * * The question * * * is, whether because one who in fact receives payment for services * * * is taxable only on his receipt of the payments, he can escape all tax by giving away his right to income in advance of payment. If the taxpayer procures payment directly to his creditors of the items of interest or earnings due him * * * or if he sets up a revocable trust with income payable to the objects of his bounty, * * * he does not escape taxation because he did not actually receive the money.
>
> "[I]ncome is 'realized' by the assignor because he, who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants." *Id.* at 116–17 (footnotes omitted).

In *Lucas, supra,* the taxpayer contracted with his wife to receive all earnings of either of them as joint tenants. The Court held that the taxpayer could be taxed on the whole of his salaries and fees earned by him during the tax years in question. *Hulbert, supra,* involved the sale of a partnership business with the provision that the sellers were to continue to operate the business until the date of consummation of the agreement and that one-half of the net profits during that period be paid directly to the buyer and the other half be retained by the sellers and applied against the purchase price. The court, holding the sellers liable for income tax on the entire amount of profits earned during the interim period, stated, "[t]he power to dispose of income is the equivalent of ownership of it and the exercise of the power to procure its payment to another is within the reach of the statute taxing income." *Hulbert* v. *C.I.R., supra,* at 401. The government argues that *Lucas* and *Hulbert* control this case because Permanente earned the trust payments as compensation for medical services, because the payments, from Kaiser's standpoint, were irrevocable and unconditional, and because Permanente, by contracting that the payments be made into the retirement plan, directed their disposition.

There is, however, a crucial element present in both *Lucas* and *Hulbert* that is missing here. Permanente never had the right itself to receive the payments made into the trust as current income. In *Lucas* the taxpayer had the right to receive his salary and fees and would have received them but for the anticipatory contract with his wife. Likewise, in *Hulbert,* the partnership, had it chosen not to enter the sale agreement or had it entered one under different terms as to the disposition of interim profits, would have received the whole of interim earnings as current income. In this

case the parties stipulated that "[t]he payments which [Kaiser] agreed to, and did make to the trust, were paid solely to fund the retirement plan, and were not otherwise available to [Permanente] or to the individual members or employees thereof." Furthermore, the Medical Service Agreement between Permanente and Kaiser provides that in the event Permanente establishes a retirement plan approved by Kaiser, Kaiser's contributions to the plan are to be *in addition* to all other sums payable by Kaiser. Thus, had Permanente elected not to establish the retirement plan, it could not have received additional current income. Nor is there any evidence in the record to suggest that Permanente agreed to accept less direct compensation from Kaiser in exchange for the retirement plan payments. That Kaiser would not have been willing to make the payments except into the trust under the conditions imposed is consistent with the primary purpose of the retirement plan: to insure Kaiser a stable and reliable group of physicians. The payments are to be viewed not as compensation for immediately past medical services but as compensation for the continued, long-term services of individual physicians. When the transaction is viewed in this light, the partnership becomes a mere agent contracting on behalf of its members for payments to the trust for their ultimate benefit, rather than a principal which itself realizes taxable income. We therefore conclude that Permanente, never having had the right to receive the income, could not have diverted it to others. Permanente's election to account for income on the accrual basis does not alter the result. A right that could never have attached could never have accrued. *Cf. North American Oil Consolidated* v. *Burnet*, 1932, 286 U.S. 417, 423.

The foregoing discussion of the government's diversion of income theory is based upon the assumption

that the government's "entity" theory as to the taxation of partnership income is correct, an assumption which we make but do not necessarily adopt. If on the other hand, the taxpayers' "conduit" theory were adopted, the same result would be reached. The individual partners did not divert income owing to them to the trust any more than the partnership did. Had there been such a diversion, it may well be that the members of the partnership would each be taxable on their share of the diverted income without regard as to whether the "entity" theory or the "conduit" theory is the correct one.

Because the taxpayers, whether viewed as individuals or as partners, realized no income in the years the payments were made to the trust, we affirm the district court's decision that they cannot now be taxed.

Affirmed.

United States Court of Appeals for the Ninth Circuit

No. 24,170–75

JAMES A. BASYE AND EVELYN E. BASYE, PLAINTIFFS-APPELLEES

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

ORDER

Before: MERRILL, DUNIWAY and HUFSTEDLER, *Circuit Judges.*

The opinion of this court, filed on September 16, 1971, as printed, is hereby modified in the following respects:

1. By striking out the sentence appearing in the last two lines of page 3 of the printed opinion reading

as follows: "This part of the Commissioner's determination is not now contested." [Page 34, herein.]

2. By striking out the sentence appearing at lines 4 and 5 of page 4 of the printed opinion reading as follows: "The latter assessment is the one in dispute here." [Page 34, herein.]

3. By placing after the word "account" in line 4 of page 4 of the printed opinion footnote reference 1. [Page 34, herein.]

The petition of appellees for a rehearing is denied.

APPENDIX C

United States Court of Appeals for the Ninth Circuit

No. 24170, D.C. #44352

JAMES A. BASYE AND EVELYN E. BASYE, PLAINTIFFS-APPELLEES

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

Judgment

Appeal from the United States District Court for the Northern District of California.

This cause came on to be heard on the Transcript of the Record from the United States District Court for the Northern District of California and was duly submitted.

On consideration whereof, It is now here ordered and adjudged by this Court, that the judgment of the said District Court in this Cause be, and hereby is affirmed.

A true copy:

Attest: December 1, 1971.

WM. B. LUCK,
Clerk.

By EMIL E. MELFI,
Chief Deputy.

Filed and entered, September 16, 1971.

United States Court of Appeals for the Ninth Circuit

No. 24171, DC# 44353

JACK J. COOK & CAROL L. COOK, PLAINTIFFS-APPELLEES

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

Judgment

Appeal from the United States District Court for the Northern District of California.

This cause came on to be heard on the Transcript of the Record from the United States District Court for the Northern District of California and was duly submitted.

On consideration whereof, It is now here ordered and adjudged by this Court, that the judgment of the said District Court in this Cause be, and hereby is affirmed.

A true copy.

Attest: December 1, 1971.

WM. B. LUCK,
Clerk.

By EMIL E. MELFI,
Chief Deputy.

Filed and entered, September 16, 1971.

United States Court of Appeals for the Ninth Circuit

No. 24172, DC# 44354

MAURICE C. FISHLER & PHYLLIS H. FISHLER,
PLAINTIFFS-APPELLEES

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

Judgment

Appeal from the United States District Court for the Northern District of California.

This cause came on to be heard on the Transcript of the Record from the United States District Court for the Northern District of California and was duly submitted.

On consideration whereof, It is now here ordered and adjudged by this Court, that the judgment of the said District Court in this Cause be, and hereby is affirmed.

A true copy.

Attest: December 1, 1971.

WM. B. LUCK,
Clerk.

By EMIL E. MELFI,
Chief Deputy.

Filed and entered, September 16, 1971.

United States Court of Appeals for the Ninth Circuit

No. 24173, DC# 44355

HENRY DONALD GRANT & JEAN N. GRANT,
PLAINTIFFS-APPELLEES

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

Judgment

Appeal from the United States District Court for the Northern District of California.

This cause came on to be heard on the Transcript of the Record from the United States District Court for the Northern District of California and was duly submitted.

On consideration whereof, It is now here ordered and adjudged by this Court, that the judgment of the said District Court in this Cause be, and hereby is affirmed.

A true copy.

Attest: December 1, 1971.

WM. B. LUCK,
Clerk.

By EMIL E. MELFI,
Chief Deputy.

Filed and entered, September 16, 1971.

United States Court of Appeals for the Ninth Circuit

No. 24174, DC# 44356

WILLIAM S. HUNTER AND JESSAMINE S. HUNTER,
PLAINTIFFS-APPELLEES

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

Judgment

Appeal from the United States District Court for the Northern District of California.

This cause came on to be heard on the Transcript of the Record from the United States District Court for the Nothern District of California and was duly submitted.

On consideration whereof, It is now here ordered and adjudged by this Court, that the judgment of the said District Court in this Cause be, and hereby is affirmed.

A true copy.

Attest: December 1, 1971.

WM. B. LUCK,
Clerk.

By EMIL E. MELFI,
Chief Deputy.

Filed and entered, September 16, 1971.

United States Court of Appeals for the Ninth Circuit

No. 24175, DC #45575

GEORGE W. SOROKOWSKI AND NADIA SOROKOWSKI,
PLAINTIFFS-APPELLEES

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

Judgment

Appeal from the United States District Court for the Northern District of California.

This cause came on to be heard on the Transcript of the Record from the United States District Court for the Northern District of California and was duly submitted.

On consideration whereof, It is now here ordered and adjudged by this Court, that the judgment of the said District Court in this Cause be, and hereby is affirmed.

A true copy.

Attest: December 1, 1971.

WM. B. LUCK,
Clerk.

By EMIL E. MELFI,
Chief Deputy.

Filed and entered, September 16, 1971.

APPENDIX D

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 61. GROSS INCOME DEFINED.

(a) *General Definition.*—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;

* * * * *

(13) Distributive share of partnership gross income;

* * * * *

SEC. 401. QUALIFIED PENSION, PROFIT-SHARING, AND STOCK BONUS PLANS.

(a) *Requirements for Qualification.*—A trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries shall constitute a qualified trust under this section—

(1) if contributions are made to the trust by such employer, or employees, or both, or by another employer who is entitled to deduct his contributions under section 404(a)(3)(B) (relating to deduction for contributions to profit-sharing and stock bonus plans), for the purpose of distributing to such employees or their beneficiaries the corpus and income of the fund accumulated by the trust in accordance with such plan;

(2) if under the trust instrument it is impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part

of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, purposes other than for the exclusive benefit of his employees or their beneficiaries;

* * * * *

(4) if the contributions or benefits provided under the plan do not discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees.

* * * * *

SEC. 404. DEDUCTION FOR CONTRIBUTIONS OF AN EMPLOYER TO AN EMPLOYEES' TRUST OR ANNUITY PLAN AND COMPENSATION UNDER A DEFERRED-PAYMENT PLAN.

(a) [as amended by Sec. 24, Technical Amendments Act of 1958, P.L. 85–866, 72 Stat. 1606] *General Rule.*—If contributions are paid by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan, or if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such contributions or compensation shall not be deductible under section 162 (relating to trade or business expenses) or section 212 (relating to expenses for the production of income); but, if they satisfy the conditions of either of such sections, they shall be deductible under this section, subject, however, to the following limitations as to the amounts deductible in any year:

* * * * *

(5) *Other plans.*—In the taxable year when paid, if the plan is not one included in paragraph (1), (2), or (3), if the employees' rights to or derived from such employer's contribution or such compensation are nonforfeitable at the time the contribution or compensation is paid.

* * * * *

SEC. 701. PARTNERS, NOT PARTNERSHIP, SUBJECT TO TAX.

A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.

SEC. 702. INCOME AND CREDITS OF PARTNER.

(a) *General Rule.*—In determining his income tax, each partner shall take into account separately his distributive share of the partnership's—

* * * * *

(9) taxable income or loss, exclusive of items requiring separate computation under other paragraphs of this subsection.

* * * * *

SEC. 703. PARTNERSHIP COMPUTATIONS.

(a) *Income and Deductions.*—The taxable income of a partnership shall be computed in the same manner as in the case of an individual except that—

(1) the items described in section 702(a) shall be separately stated, and

* * * * *

SEC. 704. PARTNER'S DISTRIBUTIVE SHARE.

(a) *Effect of Partnership Agreement.*—A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this section, be determined by the partnership agreement.

* * * * *

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In the Supreme Court
OF THE
United States

OCTOBER TERM 1971

No. 71-1022

UNITED STATES OF AMERICA,
Petitioner

VS.

JAMES A. BASYE AND EVELYN E. BASYE, et al.,
Respondents

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI
to the United States Court of Appeals
for the Ninth Circuit

QUESTION PRESENTED

In our view, the petition begs rather than articulates the question presented. The retirement plan here at issue was unique, as were the nature and relationship of the parties who established it. The question raised by the case can only be stated in terms of its special facts.

The precise question is whether moneys paid by Kaiser Foundation Health Plan, Inc.[1] into a physicians' retirement plan, established for the purpose of insuring Kaiser a stable and reliable pool of physicians providing medical services to its members, constituted current distributable income to the medical partnership whose contract with Kaiser provided for payments into the plan, despite the fact that such payments were not otherwise available to the partnership or to the individual members thereof, but were paid *solely* to fund the retirement plan.

REASONS FOR DENYING THE WRIT

1. THE DECISION IS NOT IN CONFLICT WITH LUCAS v. EARL

By omitting certain key facts from its statement of the case, and by assuming the facts to be otherwise in its phrasing of the "question presented," the government's petition seeks to make it appear that the decision of the Court of Appeals has departed from the principle of *Lucas v. Earl*, 281 U.S. 111.[2] That case held that one may not escape the tax on his earnings by anticipatory assignment thereof to another.

---

[1]We will refer to Permanente Medical Group partnership as "Permanente" and to Kaiser Foundation Health Plan, Inc. as "Kaiser," as did both the District Court and the Court of Appeals, although the government's petition uses the terms "Medical Group" and "Health Plan."

[2]In contrast to its current view that this case "impairs the integrity" of a "cornerstone in the structure of the income tax law," the government briefs to the Court of Appeals made but a single reference to *Lucas v. Earl*, in a footnote which stated that while analogous, it "need not be relied upon to support the government's position here." (App.Op.Br., fn. 29, p. 34.)

If this were such a case—if the Permanente Medical Group had simply contracted in advance to have earnings which would otherwise have been available to it paid instead to a trustee to fund this retirement plan—then the *Lucas v. Earl* doctrine might indeed apply. But this is not such a case.

This case was presented to the trial court on the basis of a written agreed statement of facts. That agreed statement eliminated any factual basis for application of the anticipatory assignment of income doctrine of *Lucas v. Earl*. In a portion of the agreed statement which the petition disregards, it was stipulated that "The payments which Health Plan agreed to, and did make to the trust, were paid solely to fund the retirement plan, and were not otherwise available to Medical Group or to the individual members or employees thereof."[2]

Both the District Court and the Court of Appeals understood the meaning and significance of that fact. Thus, after quoting that portion of the agreed statement, the Court of Appeals said:

> Furthermore, the Medical Service Agreement between Permanente and Kaiser provides that in the event Permanente establishes a retirement plan approved by Kaiser, Kaiser's contributions to the plan are to be *in addition* to all other sums payable by Kaiser. Thus, had Permanente elected not to establish the retirement plan, it could not have received additional current income. Nor is there any evidence in the record to suggest that

[2]Agreed Statement of Facts, ¶16, p. 7, lines 18-21, I-R 42:18-21 The Transcript of Record in the Court of Appeals consisted of three volumes, which will be cited herein as I-R, II-R and III-R.

> Permanente agreed to accept less direct compensation from Kaiser in exchange for the retirement plan payments. That Kaiser would not have been willing to make the payments except into the trust under the conditions imposed is consistent with the primary purpose of the retirement plan: to insure Kaiser a stable and reliable group of physicians. The payments are to be viewed not as compensation for immediately past medical services but as compensation for the continued, long-term services of individual physicians. When the transaction is viewed in this light, the partnership becomes a mere agent contracting on behalf of its members for payments to the trust for their ultimate benefit, rather than a principal which itself realizes taxable income. We therefore conclude that Permanente, never having had the right to receive the income, could not have diverted it to others.
>
> (Pet., App. B, 40.)

Under the terms of the plan, its eventual beneficiaries were not the partnership, nor its partners as such, but "participants." Whether a qualifying physician was or was not a partner in Permanente had no bearing on his status as a participant. (I-R 133, 139.) Employed physicians had precisely the same standing and status as partners. Furthermore, a participant would forfeit his rights only upon ceasing to serve Kaiser members, *not merely by leaving the partnership.* Any participant (employee or partner) leaving the partnership to join another Kaiser-affiliated physician group would take his contingent interest with him. (Plan, Article H-1, I-R 148-149.)

The significance of these provisions is simply that the plan's terms, as well as its original purpose, served the interests of Kaiser; it was designed to induce physician loyalty to Kaiser, not to Permanente.

Thus the decision is not surprising or unusual, nor is it inconsistent with *Lucas v. Earl*. Once the facts are fully and fairly stated, it is apparent that Permanente did not "deflect" a portion of its income to the retirement plan. Neither individual partners nor the partnership could have received or benefited from Health Plan's contributions except in the form of contingent and forfeitable "tentative accounts" under the plan.

The law is very clear that the rights or prospects of participants in the Plan, as participants, were simply too contingent and uncertain to constitute currently taxable income. Indeed, the government has never contended that the rights of employee-participants achieved the level of taxable income, and no deficiencies were assessed against the employee-participants. The Court of Appeals held that such contingent prospects as were conferred upon participants under the plan did not constitute current taxable income to the participants qua participants.

> . . . had the taxpayers contracted individually with Kaiser for payments into a retirement trust subject to the same conditions involved here, they would not be subject to taxation in the years the payments were made. This conclusion accords with the decisions of both the courts and the Internal Revenue Service holding that payments made into deferred compensation plans which include sub-

> stantial forfeiture provisions are not taxable until actually received or otherwise made available to the taxpayer, even though not qualifying for special treatment under §§401-404 of the Internal Revenue Code. See *Drysdale v. C.I.R.*, 6 Cir., 1960, 277 F.2d 413; *Schaefer v. Bowers*, 2 Cir., 1931, 50 F.2d 689; *Harold G. Perkins*, 1947, 8 T.C. 1051; *Julian Robertson*, 1946, 6 T.C. 1960; Rev. Rul. 67-449, 1967-2 Cum.Bull. 173.
>
> (Pet., App. B, 36)[4]

The statement of the "question presented" in the government's petition assumes what is not a fact, *i.e.*, that the payments were "compensation for services rendered by a medical partnership." (Pet., 2.) That statement of the question implies that Kaiser made payments into the plan in a given year in consideration for medical services rendered during that same year. That simply was not the fact. Kaiser's contributions to the plan were by the express terms of its contract with Permanente to be *in addition to* all other sums payable as compensation for medical services. (Medical Service Agreement, Sec. H-4, I-R 104, 105.) Since the beneficial enjoyment of those additional payments was forfeitable and contingent upon future events, they cannot be considered to be "compensation for services rendered," certainly not for medical services *currently* rendered. At most they could be considered compensation for continued future services of

---

[4]The government's present attempt (Pet., 11-12) to distinguish the cited Tax Court cases on the ground that respondents were vicariously "compensated" through the partnership assumes the very question at issue—i.e., that the partnership should be regarded as having realized income because of the anticipatory assignment doctrine of *Lucas v. Earl*.

individual participants in the plan; it required this year's work plus many more before a physician might realize benefits from the contribution.[5]

The decision of the Court of Appeals is entirely consistent with the cases cited in the government's petition. All were cases in which, *but for* an anticipatory assignment or other contractual arrangement diverting or deflecting income to a third person, the *taxpayer would have received it.* But it was stipulated in this case that Permanente would *not* have received these moneys otherwise. The Tax Court has consistently refused to apply the anticipatory assignment doctrine to situations where the taxpayer, although his efforts may have in some sense produced or

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[5]In 1960, when Kaiser's first contribution was made, the six physician litigants in the instant cases were required to perform an aggregate of fifty-four years additional service to Kaiser's membership before they would be entitled to retirement benefits under the plan. See Chart, Appellee's Brief in the Court of Appeals, p. 9.

Furthermore, upon terminating her relationship to Kaiser in 1963, Respondent Nadia Sorokowski "forfeited all rights to receive any future payments from the trust." (I-R 46.) Dr. Sorokowski's case was not exceptional. During the years 1960-1963, twenty-three physicians (roughly ten percent of the participants) terminated their services to Health Plan's members and forfeited their "tentative accounts." (I-R 45; 180.)

Each of these "forfeitures" occurred prior to September 1963, when Dr. Sorokowski left Health Plan. (I-R 180.) Since every "forfeited" account is tentatively reallocated among the remaining participants (Article E-3-b, I-R 141), Dr. Sorokowski's account, at the point of her forfeiture, included her share of the twenty-three earlier forfeitures. This she in turn forfeited to the remaining participants. It is of course impossible to say how many further forfeitures will occur before the 1960-1963 contributions are actually realized by their ultimate recipients.

Under the rubric that "income must be taxed to him who earns it," the government contends here that Dr. Sorokowski, as well as all the other physicians whose prospects of benefits stood subject to forfeiture, "earned" taxable income each year by virtue of contributions to the fund, and must be taxed accordingly. It is difficult to believe that a "principal bulwark" of the tax structure requires that result.

"earned" the income, could not, even absent the contractual arrangement under attack, have himself received it. See, *e.g., Paul A. Teschner,* 38 T.C. 1003 and *Nicholas A. Stavroudis,* 27 T.C. 583, discussed in the opinion of the District Court (Pet., App. A, 22.)

The petition assails certain language in the Court of Appeals' opinion to the effect that *Lucas v. Earl* is not controlling because "Permanente never had the right to receive" Health Plan's contributions to the trust. The government urges that the same was true of Mr. Earl, in that, after the assignment of a part of his income to his wife, he no longer had the "right to receive" that income.

But that misses the point, because Mr. Earl had control over the receipt of his future earnings until he made the assignment to his wife. In contrast, neither Permanente nor any of the individual participating physicians controlled nor had any prospect of receiving the amounts which Kaiser ultimately paid into the retirement plan.[8] As stated in the above excerpt from the Court of Appeals' opinion, there is no "evidence in the record to suggest that Permanente agreed to accept less direct compensation from Kaiser in exchange for the retirement plan payments."

The concept that "diverted" or "deflected" income is taxable to him who diverts or deflects it was broadly stated in *Hulbert v. Commissioner* (7 Cir., 1955) 227 F.2d 399, 401, a partnership case, as follows:

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[8]The rights here in question arose out of a contract resulting from arm's length negotiations between the principals. (Agreed Statement of Facts, ¶15, p. 7, I-R 42-2-9.) Those rights were defined, circumscribed and limited by that contract.

> The *power* to dispose of income is the equivalent of ownership of it and the *exercise of the power* to procure its payment to another is within the reach of the statute taxing income. . . . (401.)

In the instant case neither the partnership nor the individual physician-participant had *any such power.* It has been stipulated that the contributed funds "were paid *solely* to fund the retirement plan, and were *not otherwise available to Medical Group.*" (I-R 42.) According to the stipulation, Medical Group could not have received the funds in the form of current income; the essential element of a taxable diversion—an exercise of "the power to dispose of income"—was lacking.[7]

---

2. THE DECISION BELOW DOES NOT APPLY ANY RULE RESPECTING THE TAXATION OF PARTNERSHIP INCOME

Because it determined the "diversion of income" issue in favor of respondent, the Court of Appeals found it unnecessary to reach the partnership income issues which the government sought to inject into this case. The court stated:

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[7]Despite its narrow and unusual facts, the government extravagantly contends that this case renders *Lucas v. Earl* "an empty admonition" and suggests in the same vein that the physicians here have managed to "immunize" themselves from taxation (Pet., 7). On the contrary, as the Court of Appeals pointed out:

> The taxpayers do not contend that the payments into the trust by Kaiser should never be taxed, but they do disagree with the Commissioner as to *when* the tax ought to be imposed and *upon whom.* Because of the substantial possibility of forfeiture of the right to receive the amounts allocated to the tentative accounts, taxpayers argue, there is no current realization of income to the individual partners and taxation should be postponed until the right of receipt has become fixed. (Pet., App. B, 35)

> Because we hold that neither the partnership as an entity nor the partners as individuals realized taxable income, we find it unnecessary to choose between the "entity" and "conduit" approaches, and this opinion is not to be read as adopting either of them.
>
> (Pet., App. B, 37.)

Inasmuch as the partnership income issues were never reached, the court's decision has no significance in that area of the law, and cannot be in "conflict" with numerous partnership cases as contended by the government.

---

3. THE DECISION BELOW HAS NO SIGNIFICANCE WITH RESPECT TO THE TAXATION OF DEFERRED COMPENSATION ARRANGEMENTS GENERALLY.

Contrary to the government's third argument, this decision cannot circumvent or frustrate Section 401 pertaining to qualified retirement plans established by *employers* for *employees*, because this case involves independent contractors, not employers and employees. Moreover, tax deferment on sums contributed to pension trusts is not confined to *qualified* trusts. In non-qualified trusts for employees, if the rights of beneficiaries are, as in this case, contingent and forfeitable at the time the contributions are made, the sums contributed are not currently taxable. Reg. 1.402(b)-1(a). On the contrary, such sums become taxable only upon distribution by the trust. This appears from the last sentence of Section 402(b) of the Internal Revenue Code (as it read before 1964):

> The amount actually distributed or made available to any distributee by any such trust shall be

taxable to him, in the year in which so distributed or made available, under section 72 (relating to annuities).

Thus, the decision in this case is in accord with the treatment of other nonqualified trusts.

The government's petition goes so far as to say that "Under the decision, there is nothing to prevent partnerships, large and small, and in any business or profession, from establishing similar plans to avoid tax on whatever portion of their compensation they choose to defer." (Pet., 13.) Like the other arguments in the petition, this *ignores the very basis of the decision in this case.* The sums paid into the trust *were not otherwise available* to Permanente and hence were not partnership income which it "chose to defer."

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4. "ADMINISTRATIVE IMPORTANCE" IS NOT A GROUND FOR CERTIORARI

The petition's fourth argument is merely that this case involves a substantial amount of disputed tax and a large number of Kaiser-related physicians. (The 568 pending cases are presumably those of the physician-partners who provided medical service to Kaiser members during 1960-63, through Permanente and other medical partnerships in the Kaiser service areas of California and Oregon.) No fundamental income tax principles are shaken by the decision below; that decision is entirely consistent with the existing law; and the undoubted administrative burden which the government has generated by bringing these cases is surely not a ground for certiorari.

CONCLUSION

In summary, this case does not "impair the integrity of any "cornerstone in the structure of the income tax law." According to the agreed statement of facts, Permanente did not "deflect" income to the trust. The payments which Kaiser made to the trust, and which are the subject of this lawsuit, ". . . were paid solely to fund the retirement plan, and were not otherwise available to [Permanente] or to the individual members or employees thereof." The decision of the court below, that although respondents were partners they were not taxable in the year of contribution, is of little, if any, precedential value, except, of course, in the cases of other physicians who are participants in the same retirement plan or in several other identical plans funded by Kaiser.

We respectfully submit that the petition for a writ of certiorari should be denied.

Respectfully submitted,

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March, 1972.

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In the Supreme Court of the United States

OCTOBER TERM, 1972

No. 71-1022

UNITED STATES OF AMERICA, PETITIONER

v.

JAMES A. BASYE and EVELYN E. BASYE, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the district court (Pet. 15-29)[1] is reported at 295 F. Supp. 1289. The opinion of the court of appeals (Pet. 31-42) is reported at 450 F. 2d 109.

JURISDICTION

The judgments of the court of appeals (Pet. 43-48) were entered on September 16, 1971. By order

[1] "Pet." references are to the petition for certiorari.

dated December 10, 1971, Mr. Justice Douglas extended the time for filing a petition for a writ of certiorari to and including February 12, 1972. The petition was filed on February 9, 1972, and certiorari was granted on April 3, 1972 (R. 220).[2] The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether compensation for services rendered by a medical partnership, made payable by contract, and paid, to a trust, is income of the partnership, and therefore taxable to the partners, as the United States contends, or whether, as the courts below held, such compensation is not partnership income and will constitute income to the beneficiaries of the trust only when distributed to them.

STATUTES INVOLVED

The pertinent provisions of Sections 61, 401, 404, 701, 702, 703 and 704 of the Internal Revenue Code of 1954 are set forth in the Appendix, *infra*, pp. 26-29.

STATEMENT

Respondents are physicians and partners[3] in a medical partnership, Permanente Medical Group

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[2] "R." references are to the separately bound record appendix.

[3] "Respondents" refers collectively to James A. Basye, Carol L. Cook, Maurice C. Fishler, Henry Donald Grant, William S. Hunter, Jessamine S. Hunter, and Nadia Sorokowski,

("Medical Group"), which was organized in 1949 for the practice of medicine in California. In 1960 the partnership had over 200 physician-partners, 41 physician-employees, and an unstated number of other employees (R. 82-83). Under the partnership agreement (R. 101-113), the partners had drawing accounts varying with responsibility and seniority, but were to share equally in net earnings in excess of drawing accounts (R. 105-106). The partnership reported its income on the accrual basis, and for a fiscal year ending June 30th (R. 80-81, 82, 83, 105-106).

In 1959, Medical Group entered into a detailed written agreement (R. 114-154) with Kaiser Foundation Health Plan, Inc. ("Health Plan"), an organization supplying prepaid medical care and hospital service to its members, of whom there were approximately 359,000 in its Northern California Region. This agreement, which succeeded earlier agreements between the two organizations, was for a period of two years from July 1, 1959, through June 30, 1961, and from year to year thereafter, subject to termination or renegotiation upon written notice given by either party ninety days prior to the end of

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each of whom was a physician and partner during the years involved. Evelyn E. Basye, Jack J. Cook, Phyllis H. Fishler, Jean M. Grant, and George W. Sorokowski are parties to these actions only because they filed joint income tax returns with their respective spouses, and, in the case of Jean M. Grant for the year 1960, because she reported one-half of the community income in a separate return.

any year. Under its terms, Medical Group agreed to provide to all members of Health Plan within its Northern California Region all medical services required by or incident to membership contracts. (R. 82-88, 121-122, 123, 124-125, 133.)

With respect to compensation, the agreement provided (R. 137): "As base compensation to Medical Group for Medical Services to be provided by Medical Group hereunder, Health Plan shall pay to Medical Group the amounts specified in this Article H." Article H (R. 137-139) then set forth the two items constituting base compensation. The first, payable directly to Medical Group, was a stated amount (originally $2.61329) per member per month, subject to adjustments as provided in Sections H-2 and H-3. The second item of base compensation called for the payments that have given rise to this litigation. It was to be made up of payments required (R. 139) "In the event that Medical Group establishes a savings and retirement plan or other deferred compensation plan approved by Health Plan * * *." Though establishment of this plan was thus stated to be contingent, and was deferred for several months, it was agreed that Health Plan's contributions thereunder (later agreed to be 12 cents per member per month) should commence as of July 1, 1959 (the effective date of the agreement), and that Health Plan's obligation to make such contributions should continue only so long as the agreement or any continuation or extension generally similar to the agree-

ment should remain in effect.* (R. 83, 137-139, 162.)

The plan contemplated by the agreement was established later in 1959 by a trust agreement executed by Medical Group, Health Plan, and a bank serving as trustee (R. 158-199). Under it, Health Plan made a payment of $200,000 to the trust at the outset, and agreed to make further payments on a per-member, per-month basis during the period in which the agreement between Medical Group and Health Plan remained in effect. The funds paid to the trust, less fees and expenses, were to be paid over to an insurance company in order to pay retirement benefits to partners and physician-employees of Medical Group, computed on a complex of factors such as age, years of service, and compensation level. Tentative allocations to potential beneficiaries were made when funds were received, but no interest vested prior to retirement, and potential benefits might be lost prior to, or after, retirement by withdrawal from Medical Group for practice other than with another group serving Health Plan's members. In that event, amounts allocated to a participant's tentative account were re-allocated to the tentative accounts of other participants. Upon retirement of a partner or a physician-employee qualified by age and years of service, the amounts credited to his tentative account were to be applied to purchase a retirement income

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*In addition to the items of base compensation, it was agreed that Health Plan should also pay to Medical Group fifty percent of Net Health Plan Revenue (as therein defined), if any. (R. 139-141.)

contract. The trust was subject to amendment at any time by Health Plan and Medical Group. (R. 83, 92-97, 162-163, 164-170, 182.)

The primary purpose of this feature of the agreement was to create an incentive for physicians to remain with Medical Group, and thus to insure Health Plan that it would have a stable and reliable group of physicians providing services to its members with a minimum of turnover. However, as the respondents asserted in their claims for refund, it served also the independent, and in some respects conflicting, interests of Medical Group and the participating physicians. (R. 11, 22, 47, 51, 55, 59, 83-84.)

The agreement between Medical Group and Health Plan contemplated that membership in the partnership would change from time to time, and provided that the agreement should continue in effect regardless of the withdrawal from Medical Group of individual partners or the addition of new partners as long as most physicians than partners continued their association as then organized or as reorganized through voluntary action. The partnership agreement constituting Medical Group provided that the partnership should continue despite the death, retirement, or withdrawal of partners; it provided also for the addition of new partners, and for the method of termination of the partnership. The trust agreement also provided for its continuation as long as fifty percent of the participants continued in association or in reorganized form. In case of dissolution of the partnership or a reorganization not qualifying within the provisions for continuity, then the assets

held under the trust agreement were to be promptly liquidated, and the net proceeds distributed by lump-sum payments to the participants then entitled thereto. (R. 97, 110, 113, 135, 174, 175.)

Health Plan paid to the trust, on a monthly basis, an aggregate of more than $2,000,000 during the period from its first payment in Medical Group's fiscal year ending June 30, 1960, until it discontinued payments at a point in Medical Group's fiscal year ending June 30, 1963. Medical Group did not include these payments in its returns of taxable income, and they were not included in the partners' distributive shares of gross or taxable income. The Commissioner of Internal Revenue assessed deficiencies against the respondent partners for 1960 and 1961 on the ground that the compensation for services of the partnership constituted gross income of the partnership, deflected to the trust through contractual arrangement with Health Plan; and, therefore, that the partners were taxable on their distributive shares of such income. Respondents paid the taxes in dispute and, after their claims for refund were denied, brought these actions for refund.* (R.

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* In the case of the respondents George W. Sorokowski and Nadia Sorokowski, the assessments, claims for refund, and suit for refund included the years 1962 and 1963, in addition to 1960 and 1961. Dr. Sorokowski withdrew from Medical Group in September, 1963, and thereby forfeited rights to receive payments from the trust. In 1966, the District Director of Internal Revenue on his own initiative made an administrative determination that Dr. Sorokowski was entitled to a deduction for 1963 equal to the sum of the amounts that had been the basis for deficiency assessments made against her

81, 84-86.)

The cases were consolidated in the district court and were heard upon an agreed statement of facts (R. 80-88), accompanied by an Appendix (R. 89-100), and documentary Exhibits A through F (R. 101-204).

Both courts below held that the partnership realized no gross income from the payments made by Health Plan to the trust because the partnership never had the right to receive them. They further held that the partnership should be considered merely the agent of the partners, and should otherwise be disregarded in determining their tax liabilities. Treating the partners merely as contingent trust beneficiaries, the lower courts concluded that they would be taxable on payments to the trust only at such times as distributions were made by the trust. (Pet. 15-29, 31-42.)

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for 1960, 1961, 1962, and 1963, and computed an overpayment of the Sorokowskis' income taxes for 1963 in the amount of $3,298.58. In March, 1967, the Internal Revenue Service mailed to the respondents Sorokowski a check in the amount of $3,875.31, representing a refund of the over-assessment determined, plus interest thereon. (R. 86-87). To this, Dr. Sorokowski responded by letter from her counsel, Exhibit F (R. 204.) The United States in May, 1967, filed a protective counterclaim by way of set-off in the action by the respondents Sorokowski, setting forth the facts of this refund. The district court, in entering judgment for the respondents Sorokowski, allowed the counterclaim of the United States by way of set-off. (R. 69-71, 86-87, 210-211.)

SUMMARY OF ARGUMENT

The government's position in this case involves two steps, each grounded upon a fundamental income tax decision of this Court.

1. The first principle of income taxation was established by this Court's decision in *Lucas* v. *Earl*, 281 U.S. 111, that income must be taxed to him who earns it, and that anticipatory arrangements to deflect payment elsewhere will not serve to avoid responsibility for the tax on income from services. Accordingly, when Health Plan agreed to pay, and paid, compensation for medical services rendered by Medical Group to Health Plan's members, the entire amount of that compensation constituted partnership gross income to Medical Group, though part of it was paid, as agreed, to a trust rather than directly to Medical Group. The fact that the form of the payment served to advance the interests of Health Plan made it none the less income to Medical Group.

2. This Court held in *Heiner* v. *Mellon*, 304 U.S. 271, that each partner in a partnership must take into his current income his proportionate share of partnership income despite the fact that distribution was necessarily held in abeyance. Accordingly, the fact that part of Medical Group's partnership income was to be held in trust did not serve to avoid the partners' liability for taxation of their proportionate shares. The court below simply disregarded this fundamental aspect of the taxation of partnerships and partners, and viewed the case as involving taxa-

tion of contingent beneficiaries of a trust. But partners are liable to taxation upon their proportionate shares of partnership income without reference to whether they, or others, are beneficiaries of a trust created to receive and hold partnership income.

3. The effect of the decision below is to circumvent the limitations that Congress has imposed upon qualified pension trusts. Such trusts combine the tax benefits of current deductibility for employers with deferred taxation of employees. But their availability, both in the years here in question and subsequently, is restricted by a number of limitations, such as those against discrimination, that the trust in this case clearly does not meet. Nevertheless, the decision below affords to a clearly unqualified pension trust tax benefits that Congress has restricted to trusts meeting the rigorous standards established by the Internal Revenue Code. The effect is therefore to invite partnerships large and small, in any business or profession, to defer the taxation of as much partnership income as they may choose by the device of having such income paid directly to a trust that meets none of the requirements of qualified pension trusts.

ARGUMENT

I.

PAYMENTS MADE BY HEALTH PLAN PURSUANT TO ITS AGREEMENT WITH MEDICAL GROUP, INCLUDING BOTH PAYMENTS MADE DIRECTLY TO THE PARTNERSHIP AND THOSE MADE TO THE TRUST, CONSTITUTED PARTNERSHIP INCOME.

Section 61(a) of the Internal Revenue Code of 1954, Appendix, *infra*, defines gross income to include, among other items: "(1) Compensation for services, including fees, commissions, and similar items."

More than forty years ago, in a decision that has stood without question as one of the foundations upon which the structure of the graduated income tax has been built, this Court held in *Lucas* v. *Earl*, 281 U.S. 111, that a taxpayer who has earned compensation for services must include that compensation in his gross income even though, by effective assignment, payment has been deflected and channeled to another. The Court has subsequently described that decision as embodying "the first principle of income taxation: that income must be taxed to him who earns it." *Commissioner* v. *Culbertson*, 337 U.S. 733, 739-740. See also *Commissioner* v. *Sunnen*, 333 U.S. 591, 604.

The statements that the Court made in *Lucas* v. *Earl* set forth the basis of its decision with conciseness and clarity (281 U.S. at 114-115):

> There is no doubt that the statute could tax salaries to those who earned them and provide

> that the tax could not be escaped by anticipatory arrangements and contracts however skilfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.

Those statements of first principles bear upon this case with as much directness and force as they did upon *Lucas* v. *Earl*. Though "anticipatory arrangements and contracts" may have prevented Health Plan's payments to the trust "from vesting even for a second" in Medical Group, they can not serve to eliminate this element of the compensation for Medical Group's services from the partnership's taxable income.

There can hardly be room to question that Health Plan's payments to the trust, as well as its payments directly to the partnership, were, and were intended to be, compensation for the services rendered by the partnership under the Medical Service Agreement (Ex. B, R. 114-157). They surely were not gifts, and they were made as a direct part of the employment arrangement. The agreement called for medical services by the partnership, and explicitly included (R. 137) in "base compensation" therefor the payments to be made to the trust as well as those to be made directly to the partnership, all as detailed in Article H (R. 137-139) of the agreement. Additional

contingent compensation was provided for in Article I (R. 139-141). In Section C-3 (R. 126), in Article I (R. 139), and in Article J (R. 141), reference is made to the compensatory arrangements set forth in Article H. The trust agreement itself (Ex. C, R. 158-199) refers to Health Plan's obligation to contribute to the trust as being derived from the service agreement with the partnership, and indicates the compensatory nature of the payments by providing that they will be coterminous with the effectiveness of the agreement with the partnership (R. 162).

Despite the patent parallelism between this case and *Lucas* v. *Earl*, the court below thought that that decision was not controlling here because (Pet. 39) "a crucial element * * * is missing here. Permanente never had the right itself to receive the payments made into the trust as current income." But that was equally true in *Lucas* v. *Earl*, and the same court made much the same point when that case was before it. See *Earl* v. *Commissioner*, 30 F. 2d 898, 899 (C.A. 9). Mr. Earl made the effective assignment in 1901, and the income there in question consisted of fees and salary earned in 1920 and 1921, so that he, also, "never had the right * * * to receive the payments." It was because of that feature of the case that this Court pointed out that "the tax could not be escaped by anticipatory arrangements and contracts however skilfully devised to prevent the salary when paid from vesting even for a second in the man who earned it." It has been equally true in numerous cases following *Lucas* v. *Earl*, where de-

flecting arrangements were made prior to the rendition of services, that the taxpayer "never had the right itself to receive the payments."* And this Court's decision in *Helvering* v. *Eubank*, 311 U.S. 122, makes it clear that an attempted deflection of earned income is ineffective to avoid tax liability whether the deflecting arrangement is made before the income is earned, as in *Lucas* v. *Earl*, or after, as in *Helvering* v. *Eubank*.

The controlling fact here, as in *Lucas* v. *Earl*, is that the payments were made as compensation for personal services rendered, and those services were rendered, pursuant to the agreement, by the partners and employees of Permanente Medical Group. For more than 40 years, it has been established and accepted in our tax law that the result of these facts is that the income is taxable to the entity—individual or partnership—which rendered the services, regardless of any arrangement, anticipatory or otherwise, designed to deflect it elsewhere.

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* *Allen* v. *Commissioner*, 410 F. 2d 398 (C.A. 3), affirming *per curiam*, 50 T.C. 466; *Hicks* v. *United States*, 314 F. 2d 180 (C.A. 4); *Megibow* v. *Commissioner*, 218 F. 2d 687 (C.A. 3); *Mayes* v. *United States*, 207 F. 2d 326 (C.A. 10); *Miller* v. *Commissioner*, 144 F. 2d 287 (C.A. 4); *Villere* v. *Commissioner*, 138 F. 2d 905 (C.A. 5); *Hogle* v. *Commissioner*, 132 F. 2d 66 (C.A. 10); *Comer* v. *Davis*, 107 F. 2d 355 (C.A. 5); *Jones* v. *Page*, 102 F. 2d 144 (C.A. 5); *Commissioner* v. *Bonwit*, 87 F. 2d 764 (C.A. 2), certiorari denied, 302 U.S. 694; *Canaday* v. *Guitteau*, 86 F. 2d 308 (C.A. 6); *Saenger* v. *Commissioner*, 69 F. 2d 631 (C.A. 5). Compare the "technically elegant" arrangement held ineffective in *Griffiths* v. *Commissioner*, 308 U.S. 355, 357; *Commissioner* v. *Laughton*, 113 F. 2d 103 (C.A. 9).

As the phrasing of the Court's opinion in *Lucas* v. *Earl* anticipated, it is immaterial that, as here, the deflecting arrangement was made in the contract under which the income was to be earned, rather than by a separate instrument of assignment. *United States* v. *Joliet & Chicago R. Co.*, 315 U.S. 44; *Galt* v. *Commissioner*, 216 F. 2d 41 (C.A. 7), certiorari denied, 348 U.S. 951; *Allen* v. *Commissioner*, 50 T.C. 466, affirmed *per curiam*, 410 F. 2d 398 (C.A. 8). If a contractual arrangement to insulate a taxpayer from receipt of compensation he earned could immunize him from taxation, the force of *Lucas* v. *Earl* would be reduced to wavering admonition.[1]

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[1] This Court long ago differentiated between consensual or contractual arrangements for the deflection and division of income (*Commissioner* v. *Harmon*, 323 U.S. 44), and deflection or division imposed by law (*Poe* v. *Seaborn*, 282 U.S. 101). Cf. *Commissioner* v. *First Security Bank*, No. 70-305, decided March 21, 1972.

In *Teschner* v. *Commissioner*, 38 T.C. 1003, relied upon by both courts below, the majority stressed a factor not here present—the fact that the taxpayer had no part in negotiating or establishing the terms of the contest of which he was the winner. Otherwise, the majority in *Teschner* wrote of deflection of income, as did the court of appeals in this case, in terms of the discussion of control in *Helvering* v. *Horst*, 311 U.S. 112. While *Horst* is, of course, a leading decision on the deflection of income, it dealt with deflecting income from property where, as pointed out in *Commissioner* v. *Sunnen*, 333 U.S. 591, 603-610, ownership or control of the income-producing property, or control of the flow of income, are the appropriate determinants. But with regard to the deflection of compensation for services, the "first principle" is that "income must be taxed to him who earns it" (*Commissioner* v. *Culbertson*, *supra*, 337 U.S. at 739-740), so that "compensation for personal services * * * is an inherently non-assignable gross income item." Lyon and Eustice, *Assignment of Income*,

The fact that the formal arrangements made for payment to the trust of part of the partnership's compensation advanced the interests of Health Plan does not make the payments any the less compensation, or remove them from the broad sweep of the definition of gross income in Section 61(a). *Commissioner* v. *LoBue*, 351 U.S. 243. This Court has only recently held that increased compensation paid with a view to reducing turnover and increasing stability in employment is not for that reason any the less taxable income. *Bingler* v. *Johnson*, 394 U.S. 741. "[N]o distinction can be taken according to the motives leading to the arrangement * * *." *Lucas* v. *Earl*, 281 U.S. at 115. The view of the court of appeals (Pet. p. 40) that payments to the trust were not "compensation for immediately past medical services but as compensation for the continued, long-term services of individual physicians" is difficult to reconcile not only with the partnership obligation but also with the facts that payments varied from month to month with the number of Health Plan's members in the same fashion that direct payments to the partnership varied, that

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17 Tax L. Rev. 295, 388 (1962). See *Strauss* v. *Commissioner*, 168 F. 2d 441 (C.A. 2), certiorari denied, 335 U.S. 858, rehearing denied, 335 U.S. 888, where decision turned upon whether the deflected income was from property or from services. Even by the *Horst* standards of control applicable to income from property, there would be basis for attributing to the partnership the income paid to the trust. Medical Group, and Health Plan, acting together, had extensive powers in the administration of the trust. (R. 166-168, 170, 175, 176-178.) They had complete power to amend the trust. (R. 182.) Cf. Internal Revenue Code, Sec. 674-678. Health Plan, as a participant in these powers, was a non-adverse party within the statutory definition. Sec. 672(a) and (b).

they were to be made while, but only while, the medical service agreement with the partnership was in effect, and that membership in the partnership was subject to change (R. 108, 112, 113, 129-130, 135). But even if the court were correct in that view, the monthly payments, whether for current or for anticipated services, would be no less current income to the partnership. *Bingler* v. *Johnson*, 394 U.S. at 757; *Schlude* v. *Commissioner*, 372 U.S. 128.

If Health Plan's wish to create or encourage stability in the group of physicians who served it were the philosopher's stone that would convert payments concurrent with service into something other than gross income, we should undoubtedly find marked changes in employment patterns throughout the nation. Employers who professed to seek enhanced stability in employment would undoubtedly soon be making payments into such tax-insulated receptacles as, for example, educational trusts for the benefit of employees' children. Grateful employees would find satisfaction in the prospect of tax deferred (or possibly tax-free) dollars being devoted to their families' future welfare. Only the revenues would suffer.

In sum, if *Lucas* v. *Earl* is to retain the unquestioned authority that it has had for forty years, then all of Medical Group's "base compensation" for services, including that part paid to the trust as well as that part paid directly, must be included in partnership gross income.

II.

EACH PARTNER IN MEDICAL GROUP, INCLUDING THE PRESENT RESPONDENTS, SHOULD HAVE INCLUDED IN HIS GROSS INCOME FOR THE YEARS IN QUESTION HIS DISTRIBUTIVE SHARE OF PARTNERSHIP INCOME.

If, as we believe we have shown, the payments made by Health Plan to the trust as well as those made directly to the partnership were includable in partnership income, then each partner, including the present respondents, should have included in his gross income his proportionate share of the increased partnership income. Internal Revenue Code, Section 61 (a) (13).

Though Subchapter K of Chapter 1 of the Internal Revenue Code of 1954 greatly expanded the detail of the tax treatment of partnerships and partners,* the structural scheme now embodied in Sections 701 through 704, Appendix, *infra*, pp. 28-29, has remained unchanged since the enactment of Section II, D,* of

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*H. Rep. No. 1337, 83d Cong., 2d Sess., p. 65 (3 U.S.C. Cong. & Adm. News (1954) 4017, 4091); S. Rep. No. 1622, 83d Cong., 2d Sess., p. 89 (3 U.S.C. Cong. & Adm. News (1954) 4621, 4721, 4722).

" * * *Provided further*, That any persons carrying on business in partnership shall be liable for income tax only in their individual capacity, and the share of the profits of a partnership to which any taxable partner would be entitled if the same were divided, whether divided or otherwise, shall be returned for taxation and the tax paid, under the provisions of this section, and any such firm, when requested by the Commissioner of Internal Revenue, or any district collector, shall forward to him a correct statement of such profits and the names of the individuals who would be entitled to the same, if distributed * * *."

the Income Tax Act of 1913, c. 16, 38 Stat. 114, 166: the partnership itself is not taxed,[10] but it prepares and files a return in much the same manner that is required of an individual taxpayer,[11] and the partners are required to take into their income their distributive shares of partnership income.[12] In *Heiner* v. *Mellon*, 304 U.S. 271, this Court held that "distributive share" meant "proportionate share", rather than "distributable share", and that partners are required to take into their individual income their distributive, or proportionate, shares of partnership income even though applicable state law prevented distribution. In so holding, it referred with approval (304 U.S. at 281, n. 8) to O.D. 187, 1 Cum. Bull. 174 (1919), in which the Treasury had held that partnership income was currently taxable to the partners in the amount of their distributive shares although by contract it could not be distributed until later years. Consistently with *Heiner* v. *Mellon*, and with O.D. 187, the courts have uniformly held that part-

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[10] Sec. 701.

[11] Secs. 703, 6031.

[12] Secs. 61(a)(13), 702(a), 704. The phrase "distributive share" originated in Sec. 218(a) of the Revenue Act of 1918, c. 18, 40 Stat. 1057.

The correlative of these provisions is that amounts distributed are not taxed to a partner upon distribution unless the amount of money distributed is in excess of the partner's basis in his partnership interest. Sec. 731(a)(1). That basis is increased by the partner's distributive share of partnership income, and decreased by distributions to him, and by his distributive share of partnership losses. Secs. 705(a), 733.

ners must currently take into their individual incomes their proportionate shares of partnership income even though by reason of consensual arrangements, disputes, ignorance, concealment, the force of law, or otherwise, the partnership income was not available for distribution.[18]

It follows that if, as we have shown earlier, Health Plan's payments to the trust constituted partnership income, then the respondent partners were required to take into their income their increased distributive shares of the partnership income, despite any contractual arrangement, by trust or otherwise, to hold distribution in abeyance. Contrary to the court of appeals' understanding (Pet. 37, 41), the government's position that the payments to the trust constituted partnership gross income, and consequently gross income to the partners, does not turn on an "entity" or "conduit" theory of partnerships. Those concepts can come into play only where there is a question of characterizing income for special treat-

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[18] *Starr* v. *Commissioner*, 267 F. 2d 148 (C.A. 7); *United States* v. *Baker*, 233 F. 2d 195 (C.A. 10); *Hulbert* v. *Commissioner*, 227 F. 2d 899 (C.A. 7); *Bell* v. *Commissioner*, 219 F. 2d 442 (C.A. 5); *Commissioner* v. *Goldberger's Estate*, 213 F. 2d 78 (C.A. 3); *First Mechanics Bank* v. *Commissioner*, 91 F. 2d 275 (C.A. 3); *Bourne* v. *Commissioner*, 62 F. 2d 648 (C.A. 4), certiorari denied, 290 U.S. 650; *Beck Chemical Equipment Corp.* v. *Commissioner*, 27 T.C. 840; *deCousser* v. *Commissioner*, 16 T.C. 65; *Halkias* v. *Commissioner*, 12 T.C. 1091; *Freudmann* v. *Commissioner*, 10 T.C. 775.

ment (*e.g.*, capital gains).[14] Here there is no question that compensation for services is ordinary income to a partnership, and to a partner. See Sections 61(a)(1) and 702(a)(9). With respect to the payments here involved, the treatment is the same whatever theories of partnership may be embodied in the Internal Revenue Code.

The errors of the courts below, in addition to their disregard of *Lucas* v. *Earl*, appear to have arisen because they persisted in viewing the respondents only as contingent beneficiaries of the trust, rather than as partners in a partnership that had earned income. But the fact that the partners were also contingent beneficiaries of the trust is quite irrelevant. The government has not sought to tax the physician-employees, who were equally contingent beneficiaries. It has not sought, and does not seek, to support its assessments against the partners because they were contingent beneficiaries. The Internal Revenue Code would command the result for which we contend in this case with respect to the partnership and the partners whether only some of the partners were contingent beneficiaries of the trust, or whether the potential beneficiaries included no partners at all, but were children, relatives, or other objects of the partnership's largesse. It can hardly diminish the partners' liability for tax on their shares

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[14] See Wolfman, *Level for Determining Character of Partnership Income—"Entity" v. "Conduit" Principle in Partnership Taxation*, 19 N.Y.U. Institute on Federal Taxation 287 (1961).

of partnership income that they were the principal contingent beneficiaries of the trust.

The court of appeals persisted in this error when it concluded (Pet. 36) that had respondents "contracted individually with * * * [Health Plan] for payments into a retirement trust subject to the same conditions involved here, they would not be subject to taxation in the years the payments were made." Under *Lucas* v. *Earl*, an individual physician (or, for that matter, a corporation) contracting with Health Plan, with similar provisions for payments to a trust for himself and his employees, or for relatives or others, would be taxed currently on amounts irrevocably paid to the trust because, as to him, such payments would be no more than deflected compensation for services rendered. Cf. *Hogle* v. *Commissioner*, 132 F. 2d 66 (C.A. 10); *Jones* v. *Page*, 102 F. 2d 144 (C.A. 5). The cases upon which the court below relied (Pet. 36) would be relevant, irrespective of whether an individual, a corporation, or a partnership contracted with Health Plan, only if the government looked to the trust as a source of income to beneficiaries, such as employees, who might never receive payment. They are of no relevance where, as here, the contracting party (the partnership) was irrevocably compensated by the bargained-for payments to the trust, and where we are concerned only with the tax liabilities of the individual partners, whether they were or were not beneficiaries of the trust.

III.

THE DECISION BELOW EFFECTIVELY CIRCUMVENTS THE LIMITATIONS UPON QUALIFIED PENSION TRUSTS ESTABLISHED BY THE INTERNAL REVENUE CODE OF 1954.

Section 401 of the Internal Revenue Code of 1954, Appendix, *infra*, as effective during the years in controversy, provides for qualified pension trusts and establishes the terms upon which the Congress has sanctioned deferred compensation plans, with the tax benefits of current deductibility to the employer and deferred taxation of the employee. Among other conditions, such a trust must be "for the exclusive benefit of * * * employees or their beneficiaries." Section 401(a). Moreover, such a trust must not discriminate in favor of officers, supervisory employees, or highly compensated employees. Section 401(a)(4). Because of these conditions, there could be no qualified pension trust for the benefit of self-employed individuals, whether partners or sole proprietors, during 1960 and 1961. Though that restriction has been relaxed somewhat in later years by amendments to the Code effected by the Self-Employed Individuals Tax Retirement Act of 1962, P.L. 87-792, 76 Stat. 809, the conditions imposed even under the relaxed provisions remain rigorous, both as to discrimination in favor of highly compensated individuals, and as to amounts that may be contributed to a pension trust for the benefit of partners rather than employees.

The trust here involved, which was principally for the benefit of partners, and otherwise provided bene-

fits only for professional physician-employees,[15] could not qualify under either the standards of 1960 and 1961 or those of later years. Yet, contrary to the explicit statutory limitations on qualified pension trusts, the decision below produces for the partnership and the partners the principal tax benefits of such a trust, and thus openly invites partnerships to circumvent the requirements carefully devised by Congress as conditions to obtaining these benefits.[16] Under the decision, there is nothing to prevent partnerships, large and small, and in any business or profession, from establishing similar plans to avoid tax on whatever portion of their compensation they choose to defer.

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[15] The record herein does not establish the number of persons other than physician-employees employed by Medical Group. But the Medical Service Agreement (Ex. B, R. 114-157) by its references to Other Personnel, to union-negotiated increases in wages and salaries, and to non-discrimination in employment, makes it abundantly clear that Medical Group had a substantial number of employees other than its physician-employees. (R. 116, 121-122, 129-130, 138, 155, 156.)

[16] If the trust had constituted a pension trust for employees qualified under Section 401, the payments to the trust by Health Plan would still have constituted gross income to the Medical Group partnership but would, at the same time, have given rise to an offsetting deduction by Medical Group. However, since, on several grounds, including the fact that it was principally for the benefit of partners, the trust was not a qualified pension trust under Section 401, the offsetting deduction would be denied by Section 404, Appendix, *infra*. By ignoring *Lucas* v. *Earl* and permitting the partnership simply to be by-passed by payments to the trust, the decision below effectively circumvents the limitations of Section 404.

CONCLUSION

For the reasons stated, the judgments of the court of appeals should be reversed.

Respectfully submitted.

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APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 61. GROSS INCOME DEFINED.

(a) *General Definition.*—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;

* * * *

(13) Distributive share of partnership gross income;

* * * *

SEC. 401. QUALIFIED PENSION, PROFIT-SHARING, AND STOCK BONUS PLANS.

(a) *Requirements for Qualification.*—A trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries shall constitute a qualified trust under this section—

(1) if contributions are made to the trust by such employer, or employees, or both, or by another employer who is entitled to deduct his contributions under section 404(a)(3)(B) (relating to deduction for contributions to profit-sharing and stock bonus plans), for the purpose of distributing to such employees or their beneficiaries

the corpus and income of the fund accumulated by the trust in accordance with such plan;

(2) if under the trust instrument it is impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, purposes other than for the exclusive benefit of his employees or their beneficiaries;

* * * *

and

(4) if the contributions or benefits provided under the plan do not discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees.

* * * *

SEC. 404. DEDUCTION FOR CONTRIBUTIONS OF AN EMPLOYER TO AN EMPLOYEES' TRUST OR ANNUITY PLAN AND COMPENSATION UNDER A DEFERRED-PAYMENT PLAN.

(a) [as amended by Sec. 24, Technical Amendments Act of 1958, P.L. 85-866, 72 Stat. 1606] *General Rule.*—If contributions are paid by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan, or if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such contributions or com-

pensation shall not be deductible under section 162 (relating to trade or business expenses) or section 212 (relating to expenses for the production of income); but, if they satisfy the conditions of either of such sections, they shall be deductible under this section, subject, however, to the following limitations as to the amounts deductible in any year:

* * * *

(5) *Other plans.*—In the taxable year when paid, if the plan is not one included in paragraph (1), (2), or (3), if the employees' rights to or derived from such employer's contribution or such compensation are nonforfeitable at the time the contribution or compensation is paid.

* * * *

SEC. 701. PARTNERS, NOT PARTNERSHIPS, SUBJECT TO TAX.

A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.

SEC. 702. INCOME AND CREDITS OF PARTNER.

(a) *General Rule.*—In determining his income tax, each partner shall take into account separately his distributive share of the partnership's—

* * * *

(9) taxable income or loss, exclusive of items requiring separate computation under other paragraphs of this subsection.

* * * *

SEC. 703. PARTNERSHIP COMPUTATIONS.

(a) *Income and Deductions.*—The taxable income of a partnership shall be computed in the same manner as in the case of an individual except that—

(1) the items described in section 702(a) shall be separately stated, and

* * * *

SEC. 704. PARTNER'S DISTRIBUTIVE SHARE.

(a) *Effect of Partnership Agreement.*—A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this section, be determined by the partnership agreement.

* * * *

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In the Supreme Court of the United States

OCTOBER TERM, 1972

No. 71-1022

UNITED STATES OF AMERICA, *Petitioner*

vs.

JAMES A. BASYE AND EVELYN E. BASYE, ET AL.

Brief for Respondents

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Brief for Respondents

OPINIONS BELOW

The opinion of the district court (Pet. 15-29)[1] is reported at 295 F. Supp. 1289. The opinion of the court of appeals (Pet. 31-42) is reported at 450 F. 2d 109.

JURISDICTION

The judgments of the court of appeals (Pet. 43-48) were entered on September 16, 1971. By order dated December 10, 1971, Mr. Justice Douglas extended the time for filing a petition for a writ of certiorari to and including February 12, 1972. The petition was filed on February 9, 1972, and certiorari was granted on April 3, 1972 (R. 220). The jurisdiction of this Court rests on 28 U.S.C. 1254(1). Extensions of time to October 5, 1972 have been granted for filing this brief.

1. The abbreviations used in this brief are "Pet." for the petition for certiorari and court opinions appended thereto; "Br." for the brief for the United States; "R." for the separately bound record; and "App." for the Appendix hereto.

QUESTION PRESENTED

Whether taxable income is realized by physicians practicing medicine as partners, in the year in which the prepaid medical plan for which they work makes contributions to a retirement plan for the participating physicians, where the participants' claims to share in them have not been fully earned but are forfeitable and will remain so until specified length of service requirements shall have been satisfied.

STATUTES INVOLVED

The statutes involved are Sections 61, 402, 404, 701, 702, 703, 704 and 761 of the Internal Revenue Code of 1954. Their pertinent provisions and those of the Treasury Regulations involved are set forth in the Appendix, *infra*.

STATEMENT OF THE CASE

Because the statement of facts made by the Court of Appeals after reviewing the record is concise and complete, we do not adopt petitioner's statement but instead restate the facts stated by the Court of Appeals in substance but not verbatim (Pet. 31-35):

The case was submitted to the district court on the parties' agreed statement of facts. Taxpayers are physicians who, during each of the tax years involved, were general partners in the Permanente Medical Group (Permanente), a limited partnership organized in 1949 to practice medicine in California. The Articles of Partnership provide that "all earnings by any of the partners from the practice of medicine * * * shall belong to the partnership," and that each partner's "compensation shall be restricted to his distributive portion of the earnings of the partnership." The partnership employed the accrual method in the information returns that it filed for the years involved in these cases; taxpayers reported their individual income by the cash method. (Pet. 31-32.)

Before the tax years in question, Permanente contracted with Kaiser Foundation Health Plan, Inc. (Kaiser) to provide medical services to members of Kaiser in its Northern California region. Kaiser, a non-profit corporation (R. 82, para. 12), operates a pre-paid hospital and medical care program for its dues paying members. The contract between Permanente and Kaiser provides for exclusivity of service—Kaiser agrees not to contract with other physicians for medical services in its Northern California region and Permanente agrees not to render such services to other direct service, prepayment plans. Under the contract Kaiser pays Permanente as compensation for the services of its physicians a monthly sum based on the size of Kaiser's membership. In addition, the contract contemplates the creation of a retirement plan to which Kaiser would make additional payments. Such a plan was established to take effect July 1, 1959, by a trust agreement between Kaiser, Permanente and Bank of America National Trust and Savings Association, as trustee.[2] This retirement plan is the focal point of the tax controversy. (Pet. 32.)

The primary purpose of the retirement plan is to insure Kaiser a stable and reliable pool of physicians providing medical service to its members. The plan accomplishes this purpose by creating an incentive for physicians to devote their careers to Kaiser members, either by remaining with Permanente or by joining some other group of physicians contracting to serve Kaiser members in one of Kaiser's other regions. (Pet. 32; the court's statement is based on R. 83, para. 16.)

Under the plan, Kaiser makes payments into the trust each month as partial compensation for the services of

---

2. The physicians worked for six months without it, because it was not adopted until Dec. 1959 but was retroactively effective on July 1, 1959. (R. 83, para. 13.)

participating physicians. Any physician with a minimum of two years service in Permanente, whether or not a partner, is eligible to participate in the plan. Each participant is assigned a certain number of "units" based on such factors as his salary, his past service with Permanente and his age at the time of his association with Permanente. The payments to the trust by Kaiser plus interest accrued on corpus less fees and expenses are tentatively credited to each participant's account in proportion to his assigned number of units. (Pet. 32-33.)

When a participant retires, the total amount allocated to his account is used to purchase a retirement annuity contract. Until then his account remains merely "tentative" because the amount allocated to it may change or his right to receive it at all may be defeated by the occurrence of one or more specified contingencies. First, if a participant in the plan leaves Permanente for reasons other than death or disability before either age sixty-five and the completion of ten years service, or the completion of fifteen years continuous service, and does not thereafter join another medical group serving Kaiser members elsewhere, he forfeits all rights to the amount allocated to his tentative account. In the case of forfeiture, the amount forfeited is reallocated among the accounts of the remaining participants; none is ever repaid to Kaiser. Second, a participant will forfeit his right to further unpaid benefits even after he has become eligible to receive them if he renders professional services for a competitor of Kaiser or if, while able to do so, he refuses to render consulting services to Kaiser or its affiliates. Third, if Permanente is dissolved or reorganized, and if at least fifty per cent of the participants in the retirement plan reassociate with the reorganized Permanente or with another group serving Kaiser members, the trust fund remains intact and unretired participants who do

not join the new group forfeit their accrued benefits. The forfeiture will not occur in two circumstances: (a) by mutual agreement Kaiser and Permanente could use the trust funds to support a new retirement plan which would preserve the tentative accounts of all participants; (b) in the case of dissolution or reorganization without the fifty per cent regrouping, the trust fund is to be liquidated and the proceeds distributed pro rata to all participants. (Pet. 33-34.)

During the four tax years involved Kaiser paid into the trust fund a total amount in excess of two million dollars. Net earnings on the corpus amounted to an additional sixty thousand dollars. Permanente did not report these amounts in its partnership income returns, nor did the partners include them in their individual returns. The Commissioner of Internal Revenue determined that the omission of these sums resulted in an understatement of partnership income and in deficiencies in the income tax returns of each of the partners. In computing the deficiencies, the Commissioner calculated the total amount of trust net receipts attributable to tentative accounts of Permanente's employees in the retirement plan, and allocated this sum among the partners according to their distributive shares of partnership income. With regard to each partner's own tentative account in the retirement plan, the Commissioner treated the "unit" allocations as a modification of the distribution provisions in the partnership agreement and assessed each partner for the annual increment attributable to his own account. (Pet. 34, 41-42.)

There is no evidence in the record to suggest that Permanente agreed to accept less direct compensation from Kaiser in exchange for the retirement plan payments. (Pet. 40.) Had a participant elected not to join the plan, he could not have received any of Kaiser's contributions as current

income in lieu of payments into the trust.[3] The tentative accounts cannot be assigned. (Pet. 36.)

"The taxpayers do not contend that the payments into the trust by Kaiser should never be taxed, but they do disagree with the Commissioner as to *when* the tax ought to be imposed and upon *whom*. Because of the substantial possibility of forfeiture of the right to receive the amounts allocated to the tentative accounts,[4] taxpayers argue, there is no current realization of income to the individual partners and taxation should be postponed until the right of receipt has become fixed. The government, on the other hand, prefers to tax now and to treat the amount on which the tax is paid as an addition to each partner's basis in his respective partnership share. Should a partner subsequently forfeit the amount in his tentative account, he would get a capital loss for that which was taxed earlier as ordinary income."[5] (Pet. 35.)

"This case thus presents the question whether the payments by Kaiser into the retirement trust were income realized by the taxpayers in the years in which the payments were made." (Pet. 35.)

---

3. The stipulation of facts states that (R. 84, para. 16): "The payments which Health Plan (Kaiser) *agreed to* . . . were paid solely to fund the retirement plan, and *were not otherwise available* to Medical Group or to the individual members or employees thereof." (Emphasis ours.)

4. "During the years 1960-1963, twenty-three physicians forfeited tentative accounts totaling in excess of $60,000.00." (Pet. 35, footnote 3).

5. "In the trial court, the government took the position that a forfeiture gave rise to an ordinary loss deduction in the year of forfeiture equal to the entire amount of tentative accruals on which the tax had been paid in earlier years. Each remaining participant then had ordinary income in the amount his account was augmented by the forfeiture." In the Court of Appeals, the government changed its position to one in which the loss is limited to a capital loss. (Pet. 35, footnote 3.)

The district court consolidated the cases for trial (Pet. 31; R. 74), decided all issues in favor of the taxpayers (Pet. 31, 29) and entered judgment accordingly (Pet. 29). On appeal the United States abandoned its contention that the investment income of the trust was taxable to the taxpayers instead of the trust (Pet. 34, note 1), but appealed the remaining issue, which is set forth immediately above exactly as the Court of Appeals stated it. The Court held "first that, viewing the taxpayers solely in their individual capacities as participants in the retirement plan, there is no current realization of taxable income." (Pet. 35.) It held secondly that assuming "without deciding, that taxability is determined at the partnership level" (Pet. 37) this partnership has not realized taxable income (Pet. 38). Its reasons cover three pages of the record (Pet. 38-40, inc.) and cannot fairly be summarized in a sentence, but we believe the climax of the reasoning is reached (Pet. 40) where the court said that the Kaiser contributions to the trust were both forfeitable and compensation not for "immediately past medical services but . . . for the continued, long-term services of individual physicians."

The decision is here for review on certiorari.

SUMMARY OF ARGUMENT

Introduction. The issue in this case is one of time: when do amounts which are forfeitable become taxable income? Petitioner's principal argument is that under *Lucas v. Earl*, 281 U.S. 111 (1930), these amounts are the income of the partnership and cannot be assigned. Yet, the issue here is not one of anticipatory assignment, but whether the Kaiser contributions have yet become income on either the cash or accrual basis.

I. A. Petitioner seeks to establish a harsher rule of taxation against taxpayers who are partners than would be

applicable under established law if they contracted as individuals. The case law, which is not based on an express statute, holds that forfeitable employer contributions to a retirement plan are not within the definition of "gross income." It, therefore, applies to independent contractors and employees alike. Present statutory law, I.R.C. Sec. 402(b), now expressly provides that if taxpayers had contracted as employees under a nonqualifying plan such as this they would not be taxable on Kaiser's contributions to the trust because their rights are forfeitable. The administrative position accepting this view of the law is shown by Treas. Reg. Sec. 1.402(b)-1(a) (affecting employees in nonqualifying plans), by Treas. Reg. Sec. 1.451-2 (affecting all persons with income claims subject to forfeiture), by published acquiescences in Tax Court cases holding that forefeitable rights in employer contributions to funded pension plans are not gross income as defined in what is now Sec. 61(a), and by two revenue rulings. It is therefore clear that, because taxpayers rights were inchoate rather than vested, no assertion of tax on these forfeitable claims would have been made if the individuals had contracted directly with Kaiser either as independent contractors or employees.

B. If taxpayers had contracted individually with Kaiser, the decisions of this Court would disapprove any assertion of liability for tax on these contingent and forfeitable claims, under either cash basis or accrual basis principles. *North American Oil Consolidated v. Burnet*, 286 U.S. 417 (1932) held that where the ownership of income is contingent on the outcome of litigation and is in the possession of a receiver, it is not taxable to anyone until paid to one of the claimants. Similarly, in *United States v. Safety Car Heating & L. Co.*, 297 U.S. 88 (1936), a claim for damages for patent infringement prior to March 1, 1913 which was being contested in court on that date, was held not to be

capital on that day but to become accrued, taxable income later when the right to it was established. As Mr. Justice Cardozo expressed the rule (297 U.S. at 99), an "inchoate and disputed claim" is not accrued income. "Income * * * is the fruit * * *, not the potency fruition."

Petitioner's case, therefore, must be that taxpayers should be more harshly taxed as partners than they would be had each contracted as an individual physician.

II. A. Congress has not displayed any intention of taxing persons more harshly if they do business as partners instead of as individuals. It has said that "Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities" (Sec. 701), which shows that it thinks of them as individual taxpayers conducting business together, not as persons liable for the tax on the income of an entity. Employing the same concept, Sec. 703 commands that "The taxable income of a partnership shall be computed in the same manner as in the case of an individual * * *." This command requires that the income of the partnership be not greater than the aggregate of the incomes of the partners, computed as if each had engaged in the business as an indivdual. Since the Kaiser contributions to the trust would not be income to the individuals contracting as individuals, the contributions are not included in the income base which is aggregated to become the income of the partnership.

This literal interpretation of the statutes is supported by the legislative history (S. Rep. No. 1922. 83d. Cong., 2d Sess. (1954) p. 376), which states that in these sections (Secs. 701-703) Congress provided for conduit treatment. Finally, our interpretation is supported by this Court's position in *Neuberger v. Commissioner*, 311 U.S. 83 (1940), where this Court applied the predecessor statutes to tax a partner as if he had done business as an individual, despite

contrary implications which cannot be found in the 1954 Code, from the *expresso unius* rule of construction. In 1954 Code Sec. 702(b) Congress has codified the particular result reached in *Neuberger*.

Taxpayers are not, accordingly, taxed more harshly because they do business in partnership than they would be if each contracted with Kaiser individually.

B. Even if we assume that the Kaiser contributions to the trust could be income to the partnership, they would represent a class of income as to which the proportionate interest of each taxpayer is unascertainable because it is wholly contingent on future events. When Congress said that each partner is taxable on his "distributive share of *any item* of income" (Sec. 704(b)), it required the ascertainment of each taxpayer's distributive share of this "item of income," not merely his "distributive share" of the ultimate net income of the partnership.

The "distributive share" of each partner means merely his "proportionate share." *Heiner v. Mellon*, 304 U.S. 271 (1938). The proportionate shares of this "item of income" are unascertainable because they are contingent and forfeitable.

Income is not taxable in the year it arises, even when it is in the possession of a receiver, if the ownership of it is uncertain because it is contingent on future events. *North American Oil Consolidated v. Burnet*, *supra*, 286 U.S. 417 (1932). *Heiner v. Mellon*, *supra*, 304 U.S. 271 (1938) is consistent with this view. There the proportionate shares of the partners were known, and so was the income of the partnership in the taxable year. The argument this Court rejected was that a state law preventing distribution of the income overrode the annual accounting concept of federal law.

Lower court decisions to the contrary relied on language found in earlier statutes, which modified "distributive" by the phrase "whether distributed or not." That phrase has been removed from the 1954 Code. There is no longer any statutory premise for the conclusion that a partner can be taxed on any "item of income" when his proportionate share of it is contingent and unascertainable.

Again, the Code equates an individual and a partner and taxes neither one on income to which his claims are contingent or forfeitable.

C. Even were the entity approach adopted, Kaiser's contributions to the trust are not an "item of income" to the partnership. The determination of ultimate ownership of the "distributive" shares of this "item" was made in the agreement with Kaiser and not in the partnership agreement (Pet. 32), and the partnership could not alter the formula in the Kaiser agreement, in which age of the participant and years of service to Kaiser, rather than years of ownership of a partnership interest, are factors (R. 183). Thus, a year's service as an employee can count as much as a year's service as a partner. The partnership does not have possession, management power, or power to determine when or to whom distribution shall be made. Neither the partnership nor its members agreed to accept smaller current income in order to obtain deferred under the retirement plan (Pet. 40), for the contributions to the plan "were not otherwise available" to them (R. 84, para. 16). Moreover, all the partners may forfeit their interests, which would mean a forfeiture by the partnership of its entire interest in the contributions. Finally, the partnership is not the one who decides whether a physician is to be a participant in the plan; each physician elects this for himself (R. 165), and he need not be a member of the partnership to do so but is eligible if he is an employee

(Pet. 32-33). The Court of Appeals correctly held that even on the entity approach, Kaiser's contributions to the trust were not the income of the partnership. *Commissioner v. First Security Bank*, 405 U.S. 394 (1972), decided after the decision below, further supports our contentions, and the views of the dissenting opinions are also consistent with them.

III. *Lucas v. Earl*, *supra*, 281 U.S. 111 (1930) and its line of authority, which are petitioner's principal premise, have nothing to do with the time when a forfeitable claim becomes taxable income. This case can and should be decided without reaching any point to which that case has relevance.

The courts below fully considered *Lucas v. Earl* and distinguished it (Pet. 38-40, 20-23). The nub of the matter is that Mr. Earl was not taxed on the income he had assigned to Mrs. Earl until he had earned it and she had received it. Here, respondents have not fully earned their rights to the contfibutions and cannot do so without further years of service. Even when payments begin, the right to have them continue is contingent on the physician's availability for consultation and his non-competition with Kaiser (Pet. 33, 17-18).

There is no occasion to extend a tax avoidance doctrine such as *Lucas v. Earl* to this case where Kaiser, for its own purposes, required deferment and possibility of forfeiture. (Pet. 32.) There is no tax avoidance here. Income will not be taxed this year, but will be taxed in a later year to each taxpayer who, by ultimately satisfying Kaiser's conditions, fully earns it and becomes eligible to receive it.

IV. Petitioner's charge that the decision below frustrates Congressional purpose expressed in 1954 Code Sections 401-404, to confine tax deferment to qualified retirement plans, entirely overlooks Sec. 402(b). In Sec. 402(b), Con-

gress provided that the beneficiary of an unqualified plan shall be currently taxable on the employer's contributions, but only if his rights in them are nonforfeitable. Hence, Congress has stated its policy: it is to refrain from taxing beneficiaries of nonqualified retirement plans so long as their rights are forfeitable. The decision below applies that policy.

There is no substance to the other charge, that this decision will undermine the statutory scheme Congress has since adopted for retirement plans for the self-employed. That scheme permits income actually received by the taxpayer to be deducted by him if paid to a retirement fund, and has nothing at all to do with the taxation of contingent, forfeitable income not received or receivable.

ARGUMENT

Introduction

This case involves the taxability of contingent and forfeitable claims to future income. The petition for certiorari and the brief of petitioner assert a conflict between the decision below and both *Lucas v. Earl*, 281 U.S. 111 (1930), and twelve decisions of six courts of appeals. Those are extravagant assertions. Not a single one of the twelve court of appeals decisions involved taxability of forfeitable employer contributions, which is all this case involves.[6] Neither did *Lucas v. Earl*.

Petitioner would extend the scope of *Lucas v. Earl* far beyond what it held. Congress has expressly provided for the result we seek in all employee cases, which are the preponderant type of case. IRC Sec. 402(a), governing qualifying plans, and Sec. 402(b), governing nonqualifying

6. To avoid constant repetition of a cumbersome circumlocution, we will refer to Kaiser as "the employer" although technically it is a principal being served by independent contractors under contracts of reciprocal exclusivity. (Pet. 32; R. 82-83.)

plans, both defer the tax until receipt. The decisions below and those on which we rely all considered *Lucas v. Earl*, and found it irrelevant, as it is.

The presentation to the Court of the true picture of the law applicable to this case requires our departure from the sequence of argument employed in petitioner's brief. We must first discuss the rules which have been developed by this Court, the lower courts, Congress, and the administrator for the taxation of contingent, forfeitable claims to income, before discussing petitioner's reliance on *Lucas v. Earl* and its line of precedent.

I. Kaiser's Contributions to the Trust Confer Entirely Contingent and Forfeitable Possibilities of Future Income on Which Respondents Would Not Be Taxable If Each One Had Contracted Directly with Kaiser Instead of Through a Partnership.

A. INCOME IS NOT CONSTRUCTIVELY RECEIVED SO LONG AS THE RIGHT TO IT IS CONTINGENT OR FORFEITABLE.

The issue in this case is not whether the payments to the trust are compensation taxable as such, but whether they represent taxable income to anyone so long as they remain forfeitable. When received, they will be taxable as compensation. That concession, readily made, does not advance by one step the analysis of the question whether they have yet become taxable income.

The United States[7] argues here for a harsher result than would prevail if each physician in the Group were a sole practitioner. Its position discriminates against partners.

If each taxpayer had his own individual contract with Kaiser, either as employee or as independent contractor, the contributions to the trust would have been treated as deferred income taxable at a later date. That result would have been clearly and unarguably so, because the rights of

7. For brevity, we hereafter refer to the United States as petitioner.

each physician were forfeitable.[8] The courts below held that the same treatment was proper here. The Court of Appeals observed that petitioner did not dispute that view below (Pet. 37), but it appears to have changed its position here (Br. 22). We will establish the proposition, accordingly, in spite of our doubt that petitioner may argue here what it did not dispute as appellant below. *Helvering v. Wood*, 309 U.S. 344, 348 (1940). The authorities for our position are judicial, statutory and administrative.

Every case which has considered the question has held that participants in retirement plans do not have taxable income from contributions to their tentative accounts if their rights are forfeitable.

Several cases so held under earlier statutes. *Schaefer v. Bowers*, 50 F. 2d 689 (C.A. 2, 1931); *Julian Robertson*, 6 T.C. 1060 (1946), Acq. 1946-2 Cum.Bull. 4; *Harold Perkins*, 8 T.C. 1051 (1947), Acq. 1947-2 Cum.Bull. 3. Each of these cases involved taxable years before the forerunner of Sec. 402(b), [Sec. 165(c) 1939 Code] was adopted. Each one therefore interpreted Sec. 22(a) of the former statutes, which contained the definition of income now found in Sec. 61(a), 1954 Code, on which petitioner relies here. It is of interest that in *Schaefer v. Bowers, supra*, which is the parent case of the rule, it was the government which successfully argued for the rule.

Under the 1954 Code, *Drysdale v. C.I.R.*, 277 F. 2d 413 (C.A. 6, 1960), also so held as an interpretation of the definition of gross income. *Doty v. United States*, 323 F. 2d 649 (C.A. 6, 1963) and *Samuel J. and Angelina Coppola*,

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8. Both lower courts found that the physicians' interests here were forfeitable when the payments into the trust were made. (Court of Appeals, Pet. 33; District Court, Pet. 17.) The United States does not dispute the fact (Br., p.5).

35 T.C. 405 (1960), Acq. 1961-2 Cum.Bull. 4 reached the same result in nonqualified plans under 1954 Code Sec. 402(b).[9]

The meaning of the definition of gross income is the same for an independent contractor as for an employee, so the cases interpreting former Sec. 22(a) [now Sec. 61(a)] did not turn on the status of the taxpayers as employees and are equally applicable to independent contractors. The same is true of *Drysdale, supra*, which involved Sec. 61(a) of the 1954 Code.[10]

The statutory authority is 1954 Code Sec. 402(b) as it read continuously from 1954 to 1969.[11] Briefly, it provides that payments by "an employer" to a "nonexempt trust" shall be "included in the gross income of any employee for the taxable year in which the contribution is made to the trust" only if the interest of the employee in that contribution is "*nonforfeitable* at the time the contribution is made."[12] (Emphasis ours.) Rarely does the Internal Revenue Code speak so clearly.

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9. Treas. Reg. 1.402(b)-1(a), discussed *infra*, p.17, is now to the same effect.

10. Neither of the two cases petitioner cites for an opposing result [*Hogle v. Commissioner*, 132 F. 2d 66 (C.A. 10, 1942) and *Jones v. Page*, 102 F. 2d 144 (C.A. 5, 1939)] involved forfeitable or otherwise contingent amounts and both involved taxability in the year of actual receipt.

11. Prior to 1969, Sections 402(a) and 402(b) placed the employee beneficiary of a qualified plan and that of an unqualified plan in exactly the same tax posture if the rights of the employee-beneficiary were forfeitable in the year the payment to the trust was made. As amended in 1969, Sec. 402(b) requires consideration of a new section, Sec. 83, but the two sections together continue to defer taxability until there is no longer a "substantial risk of forfeiture." The amendments are not retroactive. Section 402(b) is derived from Sec. 165(e) of the 1939 Code, which appeared in the 1942 Act.

12. This section is not referred to in either the brief for the United States or its petition for certiorari. Its complete text is in the Appendix, as are those of all statutes and regulations cited.

The administrative position is shown by the three acquiescences in Tax Court decisions noted above, by published rulings, and by Regulations. One ruling is Rev. Rul. 67-449, 1967-2 Cum.Bull. 173. It reveals how firm the rule is, because it held that the employee was not currently taxable on forfeitable contributions, even though he elected to participate in the forfeitable plan instead of receiving alternative benefits, because he was not in constructive receipt of them. Treas. Reg. Sec. 1.451-2, defining constructive receipt, was relied on and hence the ruling is not confined to employees.

Finally, the administrative view is shown and, we should have thought but for the petitioner's arguments here, foreclosed, by Treas. Reg. Sections 1.402(b)-1(a) and 1.451-2 (Appendix, *infra*). The first regulation repeats the statutory provision that the employer's contribution to the trust shall be included in the employee's income only if "nonforfeitable at the time the contribution is made," and then adds that if the contributions were forfeitable at the time they were made they do not become taxable to the employee until actually paid to him. Only the last sentence of the regulation may have been changed by the 1969 amendment to the Code, which has added Sec. 83 and may impose some tax when the employee's interest vests; i.e., becomes nonforfeitable.

The second regulation is Treas. Reg. Sec. 1.451-2. It defines "Constructive Receipt of Income" as:

> "Income . . . not actually reduced to a taxpayer's possession (but) . . . credited to his account, set apart for him, or *otherwise made available* so that he may draw upon it at any time." (Emphasis ours.)

The stipulation of facts states that:

> "The payments which Health Plan (Kaiser) agreed to . . . were paid solely to fund the retirement plan,

and *were not otherwise available* to Medical Group or to the individual members or employees." (Emphasis ours.)

The stipulation in the exact words of the regulation means the payments were not constructively received, and the court below so held.

Moreover, the regulation continues by saying:

". . . . However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions." (Reg. 1.451-2).

There can be no doubt that the physicians' "control of the receipt" of the contributions here in question was "subject to substantial limitations or restrictions," since the contributions were forfeitable when made and in the case of one respondent have actually been forfeited (Pet. 20, footnote 3). Here, then, is further administrative evidence that had the physicians contracted directly with Kaiser, the result below would have been unquestioned.

No distinction is made in Treas. Reg. Sec. 1.451-2 between employees and independent contractors, so nothing would have turned on which status they assumed. Indeed, Treas. Reg. Sec. 1.61-2(d)(5), interpreting the income status of property transferred as compensation but subject to restrictions, expressly states that the same rules apply to independent contractors as to employees.

Income cannot be said to have been earned if its receipt is subject to the requirement that the earner perform future services. Moreover, such a requirement involves a possible forfeiture and prevents constructive receipt of income which a taxpayer may never receive. As we shall show, *infra* B, it would also prevent the accrual of in-

come.[13] Such a requirement is of critical importance where the employer pays the contributions over to a trustee or other third person for the taxpayer's possible ultimate benefit. But its absence is not critical where the employer merely promises to pay fully earned but nonfunded compensation in the future. There, the fully earned but deferred income is not taxable until paid if the contract deferring the payment is made before the services are performed, whether the deferred income is forfeitable or not.

The Revenue Service has so ruled in Rev. Rul. 60-31, 1960-1 Cum.Bull. 174, where it analyzed the court decisions and stated its interpretation of them in five situations involving earned but deferred compensation, four of which were not payments to a trustee or otherwise funded. The ruling agrees that where compensation is earned after an employment contract has been signed and that contract provides that a portion of the compensation earned will be withheld by the employer and paid to the taxpayer when he retires, but without purchase of an annuity, or other funding, the tax is not due on the withheld income and is deferred until the income is actually received by the employee. The ruling is not confined to employee cases, because one example given of properly deferred income is that of an author and his publisher.[14]

Forfeitability is not a requirement for the deferral of income approved in Rev. Rul. 60-31 where the employer does not fund the obligation by paying the withheld funds to a trustee, or by buying an annuity.

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13. As the Court of Appeals stated (Pet. 32-33), the principal purpose of the entire plan was Kaiser's purpose to bind the physicians to its service, and the forfeiture provisions were the keystone.

14. This is a cash basis ruling. Respondents are all on the cash basis (Pet. 32). Because the partnership is on the accrual basis (Pet. 32) we show in point IB, *infra*, that forfeitability also prevents accrual.

In that ruling, the Revenue Service also announced its acquiescence in *Commissioner v. Oates*, 207 F. 2d 711 (C.A. 7, 1953), affirming 18 T.C. 570. 1960-1 Cum.Bull. at p. 180. The facts from the ruling which we have stated above were substantially those of the *Oates* case, except that in *Oates* the employer who withheld the deferred income was Northwestern Mutual Life Insurance Company, and Oates was a partner in a general insurance agency and hence an independent contractor like respondents here. Where deferred compensation is funded by the purchase of annuities, companies like Northwestern are the underwriters of the annuities. The Service's position is that if the employer buys an annuity for someone who performs services for it, payable in the future, the employee is immediately taxable on the premium unless the policy is forfeitable, but if the same company as employer promises to pay in the future, and if the contract so providing is in existence when the services are performed, as was the case in *Oates*, the deferred compensation is not taxable until received, even if it is not forfeitable. Rev. Rul. 60-31, *supra*.

No better illustration of the rules can be found than the tax status of payments to federal judges who are entitled to retire on full compensation. The governing statute provides that when one of the prescribed combinations of age and length of service occurs, the judge becomes eligible to resign or retire, and in either case to continue to receive his full salary for life. Title 28, United States Code Sec. 371. Although he is free without forfeiture to postpone his retirement after eligibility vests, he does not increase his income by so doing. Nor does he, by accepting temporary judicial assignments after retiring, succeed in increasing either his judicial salary or his retirement annuity, for they are the same in amount.

Thus, the judge has fully earned his retirement compensation at the moment he becomes eligible for retirement.[15] Nothing more need be done to assure him the continuation of his full judicial salary for the rest of his life; his rights have fully vested. The same argument, that he has constructively received it all at that moment,[16] could be made as the Commissioner made in the *Oates* case. The Tax Court summarized the Commissioner's argument and its own views as follows (18 T.C. at 585):

> "Respondent in contending that the amounts in question are taxable to petitioners under section 22(a) largely relies on *Lucas v. Earl*, 281 U.S. 111, *Helvering v. Eubank*, 311 U.S. 122, and *Helvering v. Horst*, 311 U.S. 112. We fail to see where those cases have any application here. Those are cases where the income had been assigned to another and the taxpayer was contending that the assignment relieved him of taxation on the income and that the income was taxable to the one to whom it had been assigned. We have no such question here. Petitioners are making no contention that the commissions credited to their accounts by Northwestern in the taxable years will not be taxable to them if and when they receive them. Their contention is that under their amended contracts which were signed prior to their retirement they were not entitled to receive any more than they did in fact receive and that being on the cash basis they can only be taxed on these amounts and that the remainder will be taxed to them if and when received by them. For reasons already stated, we have sustained that contention. Reviewed by the Court."

The Commissioner was not satisfied and appealed. The Court of Appeals affirmed the Tax Court, agreed with the

15. This is not the case with respondents here, who must continue after retirement to perform consultative services and refrain from serving competitors, in order to avoid forfeiture. (Pet. 33; R. 169-170, Sec. F-4.)

16. Subject to discount for postponement of possession.

taxpayer, and also rejected the argument based on *Lucas v. Earl*, *supra*, 281 U.S. 111 (1930), *Helvering v. Eubank*, 311 U.S. 122 (1940),[17] and *Helvering v. Horst*, 311 U.S. 112 (1940).

The court held that this Court's decision in *Massachusetts Mutual Life Insurance Co. v. U. S.*, 288 U.S. 269 (1933) was the controlling precedent,[18] rather than *Lucas v. Earl* and the cases like it.

As we have shown, the Commissioner has acquiesced in the *Oates* decision and has published Rev. Rul. 60-31, 1960-1 Cum.Bull. 174, to inform both the Revenue Service and the taxpayers that he has done so, and to state analagous facts as illustrations of acceptable tax deferment of earned but unpaid compensation.

Neither Oates nor the federal judge knows how much he will ultimately receive as retirement compensation because the payments end at death. The same is true of the taxpayers here. This is one objection to taxing taxpayers currently on their future terminable income, but there is another, which is that their rights, unlike those of the retired judge and Oates, have not vested.

The foregoing examples of the recognized rules illustrate the meaning of the Regulation which defines income as not constructively received (Reg. 1.451-2, quoted above) "if the taxpayer's *control* of its receipt is subject to substantial limitations or restrictions." (Emphasis ours.) The control the taxpayer lacked in *Oates* is over the time of

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17. Contrast of *Eubank* with *Oates* reveals the importance of the distinction between assignment of income, which *Eubank* forbade, and deferral of income, which *Oates* permits. Otherwise they are similar, even to the fact that both involved retired general insurance agents. This important distinction petitioner ignores.

18. Where interest credited but not paid by a cash basis insurance company to cash basis policyholders was held to be neither constructively received by the latter nor constructively paid by the former, and hence was not deductible or taxable until paid.

receipt, and the same control is lacking in the judge who qualified for retirement, and the physician here. Because the justification of the progressive income tax is ability to pay, that tax does not ignore restraint on availability of funds with which to pay.

B. THE CONTINGENT NATURE OF THE CLAIMS TO FUTURE INCOME PREVENTS THEIR BEING INCOME ON THE ACCRUAL BASIS.

The result is the same if accrual basis principles are supplied. The rule is that the possibility of forfeiture prevents these contributions accruing as income until there arises an enforceable right to receive them. This rule is fully supported by three landmark decisions of this Court. The earliest in time is *North American Oil Consolidated v. Burnet*, 286 U.S. 417 (1932), where net proceeds were received in 1916 by a receiver who was operating properties until litigation over their title was settled. The corporate claimant was on the accrual basis. The income was paid over to the corporate claimant in 1917. This Court held that (286 U.S. at 423):

> "... the company was not required in 1916 to report as income an amount which it might never receive."

The Court of Appeals relied on this case for its conclusion that taxpayers' forfeitable rights could not have accrued as income (Pet. 40).

The second case is *United States v. Safety Car Heating & L. Co.*, 297 U.S. 88 (1936), where a claim for damages for patent infringement prior to March 1, 1913, was contested in litigation pending on that date, and was held not to have become income to an accrual basis taxpayer before that date. Since Congress could not have taxed the recovery at all had it been income before that date, the case is a particularly powerful precedent for the rule that income does not accrue as income while the right to own it is contingent.

Some of Mr. Justice Cardozo's words for the Court bear quotation here:

> "In February, 1913 . . . there was a contested and contingent claim for profits, not fairly to be characterized as income for that year or earlier. In 1925, this inchoate and disputed claim became consummate and established. It was now something more than a claim. It was income fully accrued, and taxable as such. . . .
>
> "Income within the meaning of the Sixteenth Amendment is the fruit that is born of capital, not the potency of fruition." 297 U.S. at 99.

It is equally true that income within the meaning of the Sixteenth Amendment is the fruit born of labor, "not the potency of fruition." The physicians' contingent and forfeitable expectations have merely the "potency of fruition" and will not fruit as income until the contingencies are removed. Hence, if they had contracted directly with Kaiser, they would not have income in these years from Kaiser's contributions to the trust, even on the accrual basis.

The third case is *Brown v. Helvering*, 291 U.S. 193 (1934). Although a deduction case, it perfectly illustrates the inflexability of the rule that an enforceable obligation is required before an item can accrue. An insurance agent on the accrual basis attempted to deduct an estimated amount of anticipated return commissions from his gross commission income, and his estimate was based on the percentage of commissions he had been compelled to return in the prior years. In an opinion written by Mr. Justice Brandeis, the Court allowed him to accrue and deduct only those commissions he had become obligated to return in the current year. Probabilities would not support an accrual. Thus, even if it could be said that a physician probably would work for Kaiser until his rights vested in order to avoid

a forfeiture,[19] that probability would not support the accrual of contingent and forfeitable income.

Petitioner cites two cases (Br. 22)[20] for its assertion made here but not below that even if the physicians had contracted individually with Kaiser they would be taxable on the forfeitable payments. Neither case has any bearing on the question when items accrue as income. In each case, the income was in hand, but it was in the assignee's hand. The fact the assignor was held taxable in the year his assignee received the income cannot possibly support the view that income is taxable as accrued income while the taxpayer's rights to it are, in Mr. Justice Cardozo's words, "inchoate."

We need not carry the burden of contending that the distinction between the funded pension and the nonfunded pension is technical and artificial, though this may have occurred to the Court. It may appear artificial that if Northwestern Mutual Life had funded its obligation to Oates by placing some of its portfolio of federal bonds in a trust for him, or if the United States should fund its obligation to its retired judges by buying them annuities from Metropolitan Life or Northwestern Mutual, that would convert their status to instant taxability. The improvement in their assurance of future security is hard to detect, but in the Commissioner's eyes their tax status is infinitely worse, for they become subject to current taxation on the cost or value of the annuity contract. (Reg. 1.402(b)-1(a)(2)). Rev. Rul.

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19. The record contradicts an assertion of such probability. Respondent Sorokowski has forfeited her interest (Pet. 20) and so have 23 other physicians (Pet. 35). In the court below petitioner took the position that they were entitled to a capital loss deduction for the lost income (Pet. 35) which, however, it would first tax as ordinary income.

20. *Hogle v. Commissioner*, 132 F. 2d 66 (C.A. 10, 1942); *Jones v. Page*, 102 F. 2d 144 (C.A. 5, 1939); we have previously referred to them in footnote 10, *supra*, p. 16.

60-31, 1960-1 Cum.Bull. 174 expressly excepts funded plans from the deferment it recognizes.

This distinction between funded and nonfunded plans underlies petitioner's case here, since without it we would have the *Oates* facts, the acquiescence in it, and Rev. Rul. 60-31. We need not challenge the distinction, however, since it must be based on 1954 Code Sec. 402(b),[21] and that section expressly states its own limitation: the employee is taxable on the employer's payments into a non-exempt retirement trust only if the employee's interest is "nonforfeitable" when the payment is made.[22]

Accordingly, the position of petitioner is reduced to the proposition that, because taxpayers practiced their profession as partners, they are to be discriminated against harshly and cannot take advantage of the equitable rules established by the courts and Congress for those who contract as individuals, either as independent contractors or as employees. We shall next show that the law does not make that harsh and unjust discrimination.

II. Taxpayers Are Not Taxable More Harshly Because They Are Partners Than They Would Be If They Conducted Their Practice Under Individual Contracts With Kaiser.

The taxpayers' economic status resembled that of employees more than that of independent physicians in private practice. By joining the partnership, they became obligated to serve Kaiser with "all or substantially all of their professional time" (R. 103, cf. R. 161) so long as the contracts were in force, and if they violate that obligation before re-

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21. Which by its language applies only to employees, as does the entirety of Sections 401-404, inclusive.

22. As we have shown above (at pp. 15-16), the uniform rule of the court decisions interpreting what is now Sec. 61(a) also limits taxability to instances when the beneficiary's interest is nonforfeitable, and the Commissioner has acquiesced in them. Hence, they apply to independent contractors as well as employees.

tirement at sixty-five or fifteen years service, they forfeit all right to retirement payments from the fund established by Kaiser's contributions here in issue, as respondent Sorokowski has done (Pet. 20, N. 3).

A. THE PARTNERSHIP'S INCOME IS THE AGGREGATE OF THE EARNINGS OF ITS MEMBERS, AND ANY CLAIMS WHICH ARE NOT REALIZED INCOME TO THEM DO NOT CONSTITUTE REALIZED INCOME TO THE PARTNERSHIP.

It is their status as partners on which petitioner bases its entire case that harsher rules apply to the taxpayers than to employees and independent contractors. Petitioner's case is without merit. Except where expressly stated exceptions are provided by Congress, an individual is taxed the same whether he engages in business as an individual proprietor or as a partner.

This Court held, prior to the 1954 Code, that only where Congress has explicitly so provided will a person's doing business in partnership produce a less favorable tax result than if he did business as an individual. *Neuberger v. Commissioner*, 311 U.S. 83 (1940). The Commissioner had there argued that the doctrine of *expressio unius* produced a literal interpretation of the statute which denied a partner the same right to offset partnership profits from securities sales against his individual securities losses as he would have enjoyed had he done both in his individual capacity. This Court held that *expressio unius* is merely a rule of construction and gave rise to no more than an inference. It refused to treat the partnership as an entity and held that the purpose of Congress to treat the partnership as a reporting aggregate of individual taxpayers was clearly stated, and except where exceptions were expressly stated no construction of the statute was permissible which im-

posed higher taxes on partners than on taxpayers engaged in business as individuals.[23]

The 1954 Code should be interpreted in the same manner. Congress has said so in positive fashion. Thus, it has said in Sec. 701 that "Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities." The emphasis is on "persons carrying on business" and displays the Congressional concept that they are "persons carrying on business" and not persons owning a business entity on whose income they are taxable.

Congress has codified this Court's *Neuberger* decision in Sec. 702(b), by this language:

> "Character of Items Constituting Distributive Share. — The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under paragraphs (1) through (8) of subsection (a) shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership."

Finally, Congress has continued the 1939 Code provisions of Sections 183 and 189 by stating in Section 703(a):

> "The taxable income of a partnership shall be computed in the same manner as in the case of an individual except that—" [Listing 15 exceptions, none of which apply here].

To comply with the language of Section 703 requires initially the determination of what income each partner would

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23. In *Neuberger* this Court also cited *Croik v. United States*, 31 F. Supp. 132 (Ct. Cl. 1940) with approval (311 U.S. 83, 85, 88). In *Croik* a nonresident alien partner in two U. S. based partnerships was held entitled to exclude from taxable income his share of the foreign source income of the partnership, the court saying that the tax law taxed a partner "as though (the income) had been received by the partner directly" (31 F. Supp. at 134). In Rev. Rul. 55-415, 1955-1 Cum.Bull. 412, the Revenue Service acknowledged that the *Croik* case was approved by this Court in *Neuberger*.

have had as an individual practitioner under contract to Kaiser, and then the aggregation of those incomes.[24] The forfeitable contributions would not have been taxable income to him whether he was technically an employee [Sec. 402(b)] or independent contractor [*Schaeffer v. Bowers*, 50 F. 2d 689 (C.A. 2, 1931); *Julian Robertson*, 6 T.C. 1060; *Harold G. Perkins*, 8 T.C. 1051; Treas. Reg. Sec. 1.451-2: and cf. Rev. Rul. 60-31, and *Commissioner v. Oates*, 207 F. 2d 711, all cited *supra*]. Because the partnership's income is computed as would be that of an individual performing under a similar contract, these contributions are not includible in its income. The Court of Appeals construed Sec. 703 in that manner (Pet. 38), and did so correctly.[25]

Sec. 702(b) also contains clear inferences supporting that interpretation.[26] It directs the "flow through" of certain income, credits and deductions from the partnership to the partner, in character or classification though not, of course, in amount. As noted above, this is the codification of *Neuberger*. It means that the income, credits and deductions aggregated by a group of individuals engaged in business in partnership remain those of the individuals and their

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24. "Thus, for the purpose of tax liability the entity approach yields to treatment of the partnership as a conduit through which the individual partners are regarded as *receiving the income so computed as if they had earned it individually*." (Emphasis ours.) Surrey & Warren, *Federal Income Taxation* (1960 Ed.) pp. 1115-16.

25. From the earliest (Little, *Federal Income Taxation of Partnerships*, 1957 Supp. pp. 126-127) to the most recent (Willis *On Partnership Taxation*, 1971, pp. 41-42), the text writers agree that 1954 Code Sections 701, 702 and 703 adopt the "conduit" theory. So does Mertens (6 Mertens, *Law of Federal Income Taxation*, p. 82.)

26. Its language is:
"The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under paragraphs (1) through (8) of subsection (a) shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership."

character is not altered because they have been divided into proportionate shares. This needed saying and was not necessarily to be implied from Sec. 703 because the argument could be made, as it was unsuccessfully in *Neuberger*, that having passed through the individual to the partnership it lost its original character, and on becoming "distributive" to the partner had its original character lost or blended into something neuter called "distributive income." So it was said, in order to forestall a repetition of the arguments quieted in *Neuberger*.

The Committee Reports show that we correctly analize the Congressional purpose. The Senate Finance Committee report says of Sec. 702 [S. Rep. No. 1622, 83d Cong., 2d Sess. (1954), p. 376]:

> "This section represents no change in current law and practice. . . .
>
> "Paragraphs (1) through (7) of section (a) specifically require conduit treatment with respect to several major items of income, deductions, etc. . . .
>
> "Subsection (b) contains a 'conduit' rule which makes clear that the character of any item realized by the partnership. . . .shall be the same as though he had realized such item directly. . . ."

The reference to "conduit" treatment recognizes that the income of the partnership is merely the aggregate of that earned by "persons carrying on business as partners" (Sec. 701), and unless they first have income they cannot be the conduits through which it flows to the partnership.[27]

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27. Concerning Sections 701 and 703, the Committee Reports state that they also continue existing law. S. Rep. No. 1622, 83d Cong, 2d Sess., pp. 376, 378. See Willis, *On Partnership Taxation* (1971), Sec. 1.03, for an analysis of the varying use by Congress of both the conduit (aggregate) and entity concepts. See also the discussion in Jackson, Johnson, Surrey, Tenen and Warren, *The Internal Revenue Code of 1954: Partnerships*, 54 Columbia L. Rev. 1183, 1185-6. The authors of that article were instrumental in framing the American Law Institute draft, from which the partnership sections of the 1954 Code were largely drawn.

When Sec. 701, Sec. 702(b) and Sec. 703 are put together, we observe a clear statutory mandate that a partnership has income only if its member first has income to contribute to it, and the character of the income flows from the partner to the partnership and back again. If its character is not taxable income to the partner contributing it, neither is it to the partnership.[28]

Petitioner's contention that the partnership had entity income which its members, had they contracted directly, would not have had, is contrary to the language of the statute, its legislative history including this Court's *Neuberger* interpretation of the predecessor statute, and the detached views of authors. It gives no effect to the necessary implications of Sec. 701, and fails to give effect to Section 703. The statute says that "The taxable income of the partnership shall be computed in the same manner as in the case of an individual," (Sec. 703), and this cannot be done if the partnership has more income than the aggregate which the individuals comprising it would have had if they had done the same business as individuals. Since each individual's interest is forfeitable and has not ripened into income, it is not taxable income to the partnership.

The lower courts so held, and correctly. In refusing to charge Congress with a purpose to discriminate harshly against taxpayers because they formed a partnership instead of contracting individually, they reached the fair result which Congress has said it intended.

B. A PARTNER IS NOT TAXED ON HIS "DISTRIBUTIVE SHARE OF ANY ITEM OF INCOME" IF HIS PROPORTIONATE SHARE OF THAT ITEM IS CONTINGENT AND UNASCERTAINABLE.

An alternative argument not made below but available to us here since we are respondents, is that a partner's

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28. Also, the partner is the owner of his proportionate share of the partnership's gross income, not merely of his distributive share of its net income. Sec. 702(c). This section codifies the rule of *Craik v. United States*, 31 F.Supp. 132 (Ct. Cl. 1940), *supra* note 23. See Rev. Rul. 55-415, 1955-1 Cum.Bull. 412.

"distributive share of income"[29] does not include any "item of income" in which his proportionate interest is unascertainable. Here, we assume for argument's sake the Kaiser contributions are a current "item of income." Under Sec. 704(b), a partner is taxable on his "distributive share of any item of income." We believe that "distributive share" means the share the partner has a right to, and does not include any "item of income" to which his proportionate interest is contested, or contingent, or forfeitable and hence inchoate. This result flows from settled principles of tax law, and preserves equality of treatment between persons doing business as individuals and those doing so as partners.

Petitioner cites *Heiner v. Mellon*, 304 U.S. 271 (1938), for the contrary of this proposition, but mistakenly. In *Heiner v. Mellon*, the proportionate shares of the partners were certain and not in dispute. The dispute was over the question whether each was taxable on his known proportion of the year's net income, when the income was not distributable under local law and was subject to being wiped out by possible later losses. This Court held that "distributive" means "proportionate" (304 U.S. at 280), and, recognising that every business is taxable on its net income for that year even though that income remains at the risk of the business, sustained the tax on the known share of each partner in that year's net income.

Here, though, the proportionate share of each partner in Kaiser's contribution to the trust is entirely unknown and speculative. Each partner may prove to have no interest in it at all, and there is an equal possibility that he may have a greater interest than his present proportion because of the tontine effect of forfeitures by others.

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29. Section 704(a).

Let us test the meaning of "distributive" by a variation of the facts in *North American Oil Con. v. Burnet, supra,* 286 U.S. 417. That is the case where this Court held that a taxpayer was not taxable on income in the possession of a receiver pending litigation over the taxpayer's ownership of it. Let us consider the case of a partnership whose assets are being operated by a receiver pending disposition of litigation in the state courts in which two partners each claim a fifty per cent interest and a third one claims a one-third interest. The federal courts cannot use a tax case to render a binding adjudication of ownership so if they decide that the men are each taxable on one-third as their respective "distributive" shares, they may well tax one taxpayer on income he has no legal right to and the others on less than they own. In such a case we believe no partner can be taxed on a share he may be held in pending litigation not to own, and as in *North American Oil* and *U. S. v. Safety Car Heating & L. Co., supra,* taxation is suspended until ownership is determined.

Under the prior law, a few cases were decided contrary to this contention.[30] The most recent is *United States v. Baker,* 233 F. 2d 195 (C.A. 10, 1956), which reviews the cases on both sides. It and the cases like it relied on language in former law that a partner was taxable on his distributive share, "whether or not distribution is made."[31] The quoted words were omitted from the 1954 Code and no equivalent form of expression was substituted. We believe the *Baker* case and like cases were incorrectly decided even under prior law. It is an error

30. Every case petitioner cites (Br. 20) arose either under the 1939 Code or predecessor acts.

31. Sec. 182, 1939 I.R.C. The parent case in that line interpreted Sec. 182, Rev. Act of 1934, which taxed "his distributive share, whether distributed or not." This case was *First Mechanics Bank v. Commissioner,* 91 F. 2d 275 (C.A. 3, 1937). It was lost by the Commissioner where we believe he was right. The result in the case is a perfect illustration of why that result is wrong.

in logic to reason that because a distributive share is taxable even if not distributed it is taxable even if not known. There is no justification for the assumption made in those cases that taxes must be paid on one hundred per cent of a partnership's net income each year, regardless of uncertainties of ownership. The Code never did say so, and there is no more reason to imply such a requirement to do injustice than in the statutes involved in *North American Oil, supra*, where the 1916 income in the hands of the receiver went untaxed until 1917. Ordinarily, all the net income of a particular year is taxed to someone, but not when the proportionate ownership shares are in dispute.

But the Court need not decide whether those cases were correctly decided under prior law. Perhaps the phrase "whether or not distribution is made" was omitted to change the result of those cases.[32] Perhaps it was omitted as both mischievous and unnecessary, since it is necessarily to be implied from the holding (*Heiner v. Mellon, supra*) that "distributive" means "proportionate". Whatever the reason for the change, there is presently no statutory basis for taxing disputed or otherwise unascertainable "distributive" shares of partnership income any differently than other types of contingent income. If there ever was any statutory

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32. The legislative history does not say. The discussion of "distributive" shares is about the adoption of the "entity" approach in respect of some provisions involving the effect of the contribution of appreciated basis property on a partner's distributive share, and the "aggregate" approach being offered as an election to be made by the partnership in such instances. S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 89-94. The discussion in Jackson, Johnson, Surrey, Tenen and Warren, *The Internal Revenue Code of 1954: Partnerships*, 54 Columbia L. Rev. 1183, 1187 et seq., *op. cit.*, does not explain omission of the phrase, either, or discuss the effect of uncertainty of distributive shares. It does state, however, that Sec. 704 permits different distributive shares for each item of income. 54 Columbia L. Rev. at 1187. Hence, the fact that the uncertainty of the distributive shares relates only to one item does not prevent the other distributive shares being taxed.

basis for such discrimination against partners, it has been removed.

Our construction of the statute also avoids a serious constitutional issue. Income is to be taxed to the owner, not to a mere claimant not in possession. To a mere claimant it is inchoate, not yet income under the Sixteenth Amendment. *United States v. Safety Car Heating & L. Co.*, *supra*, 297 U.S. 88 (1936).

For the same reasons, monies these partners had no control over, no right to receive, and which were mere future claims subject to forfeiture, were not part of the "distributive" shares of the partners. Assuming that the Kaiser contributions were "an item of income" to the partnership, each partner's proportionate share in it was unpredictable and unascertainable, so it is not taxable until his share is known.

C. EVEN IF THE PARTNERSHIP COULD HAVE TAXABLE INCOME NOT AGGREGATED FROM THE INCOME OF ITS MEMBERS, IT ACQUIRED NO INTEREST IN THE KAISER CONTRIBUTIONS WHICH WOULD CONSTITUTE INCOME TO IT.

The Court of Appeals held that even on the entity theory, assuming without deciding its validity, the partnership did not have income from Kaiser's contributions to the trust (Pet. 37-38). It observed that those contributions were in addition to the payments for services made currently, and the contractual scheme did not contemplate that those contributions would be paid to the partnership for it to disburse to its members (Pet. 40). It pointed out that the contributions to the plan are "in addition to" the regular compensation and the latter would not have been increased had there been no plan. (Pet. 40.) It said that the record is barren of evidence to suggest that the partnership "agreed to accept less direct compensation from Kaiser in exchange for the retirement plan payments," and that the Kaiser

contributions "were not otherwise available" to the partnership, its members or employees, except as additions to the corpus of the fund. (Pet. 40.) Moreover, the record shows that a participant in the plan must elect to be included (R. 164-165), and his current income is not affected by his decision. The court concluded that the contributions did not constitute income to the partnership (Pet. 38, 40), even on the entity theory.

Like the Court of Appeals, we do not accept the entity approach, but we agree that even if taken it does not cause these contributions to become income to the partnership. We would add to what the Court of Appeals said that for those contributions to be income to the partnership, it should have some power to effect their reallocation among the partners, as they change from time to time. For example, if these funds are sufficiently under the partnership control to constitute income to it, then it should be the one to make the election whether to include a particular physician in the plan, and it should be able at any time to direct forfeited tentative accounts to those who are then partners, and particularly to assume control of forfeited accounts of those who are only employees, and allocate them to partners. None of these can it do, under the contract (Pet. 33; R. 164). Partners may join and become part owners of the partnership, but while they may bargain for the size of their distributive shares, they cannot bargain for any share in the tentative accounts forfeited by the partners whose vacancies they are filling, nor can the partnership direct that they are to have such a share. The contract by which Kaiser bound itself directs that the allocation of forfeited accounts is to be made to the tentative accounts of the participants, and a new partner can share only in future contributions and forfeitures (R. 166-167). Neither the partnership nor its later partners can change this.

Moreover, service as an employee means as much as service as a partner in building up a tentative account. Age and length of service of a participant are factors in determining the size of the tentative account and they are the same whether he has served as employee or partner or a combination of both. (R. 166.) The proportionate tentative account of a participant thus has no relationship to his "distributive share" of the operating income of the partnership, and indeed he may be an employee and have none of the latter but some of the former. Paradoxically, he is fortunate to be an employee and not a partner, for petitioner would tax the additions to his tentative account not to him but to the partners. Clearly, if the partnership were the owner of these contributions it should have sufficient control over them to allocate the employees' shares to the partners so they can pay the tax on them, but it lacks even this power. Lacking even this much control, it lacks the control the concept "taxable income" requires.

Finally, the partnership is even powerless to avoid the possibility that the eventual owners of all forfeited accounts will be its employees, not its partners. This is an actual possibility under the plan, and it entirely negates the notion that the partnership had a stake in these funds sufficient to represent income to it.

Subsequent to the decision below, this Court decided *Commissioner v. First Security Bank of Utah*, 405 U.S. 394 (1972). There, income which was not in fact received by a national bank, and which it could not have received lawfully, was held not properly allocable to it under 1954 Code Sec. 482. On the issue whether claims can be taxed as income before the identity of the ultimate owner is established, the decision supports our position. Indeed, the majority opinion so aptly states the rules as we see them that we can do no better than quote them (405 U.S. at 403):

"In cases dealing with the concept of income, it has been assumed that the person to whom the income was attributed could have received it. The underlying assumption always has been that in order to be taxed for income, a taxpayer must have complete dominion over it. 'The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income whether he sees fit to enjoy it or not.' *Corliss v. Bowers*, 281 U.S. 376, 378 (1930).

"It is, of course, well established that income assigned before it is received is nonetheless taxable to the assignor. But the assignment-of-income doctrine assumes that the income would have been received by the taxpayer had he not arranged for it to be paid to another."

The court below expressed precisely the same views and found as fact that the partnership could not have had the Kaiser contributions on any other terms (Pet. 40).

The dissenters in *First Security Bank* did not disagree with the majority for any reason harmful to our position here. Thus, Mr. Justice Marshall stated in his dissent that:

"This is not a case involving independent companies or private individuals where we must scrupulously avoid taxing someone on money he will never receive regardless of his will in the matter." (405 U.S. at 410.)

This case is the one Mr. Justice Marshall stated was not before him.

The dissent of Mr. Justice Blackmun, in which Mr. Justice White joined, was based on considerations peculiar to Sec. 482, i.e., that the income remained within the circle of the corporate family. No such considerations are shown here. There is no suggestion that the physicians in whose favor respondents may ultimately forfeit are their relatives.[33]

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33. The Agreed Statement of Facts states that it "is complete, and there are no material issues of fact remaining in dispute."

Nor is there any income here which the taxpayers could have had and assigned elsewhere, either without or within a related structure.

Accordingly, as the Court of Appeals held, the requisite control to constitute partnership income is absent.

III. Lucas v. Earl and Its Line of Precedents Are Irrelevant Here.

Petitioner's argument, based on *Lucas v. Earl, supra,* 281 U.S. 111 (1930), is not reached unless the Court decides each preceding argument against us. Both lower courts fully considered that case and distinguished it and its line of precedents.[34] The Court of Appeals devoted three lengthy paragraphs to analyzing it and *Helvering v. Horst, supra,* 311 U.S. 112 (1940), and an additional lengthy paragraph to distinguishing them (Pet. 38-40). Obviously, these cases were not slighted but were fully considered, even though they were first discussed by petitioner in the court below on oral argument. Its afterthought below has become its major argument here.

Petitioner's position is squarely bottomed on the entity theory, although its brief offers only assertions (Br. 20) to establish the validity of that theory. As it must even to discuss its theory of the case, petitioner speaks in terms of "services rendered by the partnership" (Br. 12)[35] and that same concept, so essential to its theory, is repeated constantly (Br. 12, 13, 14, 16, 17, as examples). Driven to find

34. Neither court discussed the cases cited by petitioner for the allegation of conflict with other courts of appeals (Pet. 6, footnote 4; Br. 14, footnote 6), probably because none of them was cited in petitioner's briefs below. As we have pointed out above (at p. 13), none of these cases involved the taxability of forfeitable amounts, or any question of the proper year to tax contingent income. They thus cannot conflict with the decision below, or support the petitioner's position here.

35. Compare the language of Sec. 701: "Persons carrying on business as partners. . . ."

words to express its contention, petitioner even refers at times to the partnership as "a taxpayer" (Br. 11, 15), which Sections 701, 702, 703 and 704 make abundantly clear it is not.

Petitioner's own statements of the rule it asks this Court to apply here are these:

> "... *taxpayer* who has *earned compensation* for services must include that compensation in *his* gross income even though, by effective asignment, payment has been *deflected* and channeled to another." (Br. 11; emphasis ours.)
>
> "... income is taxable to the entity—individual or partnership—which rendered the services. ... (Br. 14)."
>
> "If a contractual arrangement to insulate a *taxpayer* from receipt of compensation *he* earned could immunize him from taxation, the force of *Lucas v. Earl* would be reduced to wavering admonition." (Br. 15; emphasis ours except for the reference to *Lucas v. Earl*.)

Thus, petitioner conceives of the partnership as "the taxpayer," which Sections 701, 702, 703 and 704 say it is not, as the one which "rendered the services," which Sec. 701 says it is not, and as an "entity," which it cannot be in the sense of being a taxpaying entity, for it never pays any tax on its income. Yet, only in the sense that we are considering a taxpayer who normally pays the tax on his, or its, earned income can the possibility of the application of *Lucas v. Earl* even be discussed.

So the first flaw in petitioner's use of *Lucas v. Earl* is that the partnership will not pay a tax on its income, whether or not petitioner's further statement that that income has been "deflected" to the trust is true (Br. 14, 15).

Analysis of the "deflected" concept also strips it bare of substance. The partnership, not a taxpayer, is said to

have "deflected" the Kaiser contributions to the trust, which is also not a taxpayer.[36] Thus, petitioner has told the Court that *Lucas v. Earl* prohibits the deflection of income from one non-taxpayer to another!

To restore reality to any possible application of *Lucas v. Earl*, one must break through the insulation of two non-taxpayers to the actual taxpayers. The taxpayers on the net income attributed to the partnership are the partners.[37] Sec. 701. The taxpayers on the trust's receipts from Kaiser are either the partners,[38] as petitioner contends, or the partners and employees who ultimately receive them, as we contend. Now that we have penetrated that insulation, we see that the effect of what petitioner calls a deflection is primarily to defer the partners' income to the future when they will have fully earned it and can receive it, and, if our position is sustained, to tax the employee and not the partner on what is ultimately paid to the employee for his services.

Thus, our position will tax the amounts Kaiser pays as compensation for the services of a physician to the physician who performs the services, whether he be partner or employee, but not until he has fully earned this additional compensation. Petitioner's position would tax it now to someone, even though that person may never receive it, and would distort *Lucas v. Earl* to a point where it would tax the partner on income earned by his employee.

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36. The Trust is not a taxpayer with respect to these contributions, though it is with respect to the earnings their investment produces.

37. Kaiser's current payments for the employees' services are taxed to the employees, and are allowed as a deduction in computing partnership net income.

38. For some reason it does not explain here petitioner will not allow respondents a deduction for amounts the trust receives for the tentative accounts of employees.

We believe we need not expend argument in persuading this Court that the courts below did not err in refusing to distort *Lucas v. Earl* into support for taxing the partners on the earnings of their employees. There remains only the question of the taxable year in which the partners are taxable on the additional compensation paid to the trust for their own services. This is a question of the year of realization of income, and hence is a question *Lucas v. Earl* did not involve. Mr. Earl was taxed in the year Mrs. Earl received half of his earnings, not in some earlier year. Hence, *Lucas v. Earl* sheds no light on the real issue in his case.

As we have demonstrated above, the application to the taxpayers here of the realization rules applicable to other taxpayers postpones taxability on their forfeitable claims to these contributions to the years in which they receive them. Cases protecting the revenue from assignments of income from one taxpayer to another have a valid and necessary function to perform, but they are not restricted in their performance of that function if they are denied the role of taxing taxpayers now on income they cannot receive until future events occur and fix their right to receive it. The nonassignment cases are being distorted beyond recognition when they are asked to support a tax structure for those taxpayers who are partners to which no other class of taxpayers is required to submit.

The principle that income must be taxed to him who earns it will be satisfied if the physicians in this case are not taxed until they have fully earned this additional compensation for their services. To fully earn it they must perform further services. Each physician must work for Kaiser not only in this taxable year but in as many as fourteen succeeding taxable years after his two-year qualifying period (Pet. 32-33) in order to fully earn this income.

Unless it is earned by both fifteen years service and satisfaction of continuation requirements,[39] it is neither earned nor going to become his income.

The courts below found that the requirements for long service and forfeiture were for the benefit of Kaiser, to assure it a constant pool of physicians. (Pet. 32, 17.) This finding was based on the parties Agreed Statement of Facts (R. 83, para. 16). Recognizing how fatal this fact is to its effort to convert this case into a tax avoidance case so that it can invoke *Lucas v. Earl,* petitioner seeks to question that Kaiser's dominant purpose was real instead of merely professed (Br. 17). Having stipulated to the contrary, it removed that question from the case and cannot now reinject it.[40]

Finally, petitioner does not explain why what it calls an "anticipatory arrangement" to require fifteen years service in order to complete the earning of benefits should be stricken down by tax avoidance principles when a retroactive shifting of taxable income between partners is expressly authorized by 1954 Code Sec. 761(c). That section permits partners to shift income between themselves after the close of the taxable year. Presumably, Congress believed that partners would shift income only to reflect actual earnings and not to impoverish the Treasury by first impover-

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39. The service requirement is less if he sooner becomes sixty-five. Then even after retirement forfeiture can occur if the physician refuses consultation or should work for a competing health plan (Pet. 33).

40. Petitioner's further suggestion (Br. 16, footnote), that the partnership had income under the revocable trust sections (Sections 674-678) has the roles reversed. Kaiser paid the contributions to the trust so it, not the partnership, is the grantor. Each of those sections states that under the described circumstances "The grantor shall be treated as the owner. . . ." Since taxpayers are not taxable on any income of which Kaiser is "treated as the owner," those sections, if applicable, are additional support for taxpayers' position.

ishing themselves. All that this "anticipatory arrangement"[41] does in deflecting income can be done retroactively under Sec. 761(c).

In summary, the question before the Court is one of time: whether the taxpayers realized income in these taxable years from the addition to their tentative accounts of entries as to which their claims were forfeitable until by further years of service they had earned the right to receive them. *Lucas v. Earl* has no bearing on questions of the time of realization of income, where the principles are established by other lines of precedent and are not in doubt. Since the principles which *Lucas v. Earl* establish have no meaning in a case in which it might void the tax effect of an assignment by one nontaxpayer to another nontaxpayer, only the effect on the underlying taxpayers has meaning, and that effect is on time, where the applicable rules are well established, and need only to be applied to the taxpayers in the same fashion they would be applied to all other taxpayers.

IV. There Is No Carefully Devised Statutory System for Taxing Forfeitable, Contingent Future Retirement Income Which the Decision Below Could Circumvent.

Petitioner contends that the decisions below circumvent the carefully planned purpose of Congress as expressed in 1954 Code Section 401, to grant tax deferment only to those retirement plans which comply with stated restrictions.

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41. It is a play on words to call the contract "an anticipatory arrangement." It was "anticipatory" in the sense that it preceded the performance of the services. But the same contract is the source of the income and of the assignment. The taxpayers never have had any rights free of the possibility of loss through forfeiture. They have assigned nothing Kaiser would have given in any other form; they have simply failed to acquire more than it agreed to give. Thus, even if *Lucas v. Earl* controlled the time of realization of income, this case would not contain the necessary elements for its application.

Petitioner's contention is answered by a section of the Code which it does not cite: Sec. 402(b), which we will discuss. Moreover a plan such as this is not economically feasible for any employer except a tax-exempt employer, as Kaiser is here.[42]

1954 Code Sections 401-404, inclusive, deal exclusively with retirement plans established by employers for employees. A retirement plan which qualifies under all the restrictions of those sections has these characteristics: The employer gets an immediate deduction for its contributions to the plan (Sec. 404); the investment earnings of the fund are tax-free because the trust is exempt from tax (Sec. 501(a)); and the beneficiary is not taxable on anything until he receives it (Sec. 402(a)), even if his interest is not forfeitable (Treas. Reg. Sec. 1.402(a)-1(a)(1)(i)).

A retirement plan for employees which does not qualify for any reason receives contrasting treatment. The employer gets no current deduction for contributions to the trust (Sec. 404(a)), the nonqualifying trust is nonexempt because Section 501(a) exempts only qualifying trusts,[43] and if the employee's rights to contributions under a nonqualifying plan are vested when the contributions are made, the employee is taxable currently (Sec. 402(b)). However, as is the case with qualifying plans, the beneficiaries of nonqualifying plans are not currently taxable on the contributions if their right to them is forfeitable when the employer's contribution is made (Sec. 402(b)).

Congress has thus declared explicitly that its carefully structured scheme to favor retirement plans which do not

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42. The record (R. 82) states that during the years in issue Kaiser was a non-profit corporation but does not disclose the further fact that it was ruled tax-exempt by the Revenue Service.

43. Hence, this trust is taxable on the earnings of the fund and petitioner did not appeal from the District Court decision so holding (Pet. 34, note 1.)

discriminate in favor of executives and shareholder-employees, or contain other prohibited features, is not defeated by deferring the beneficiary's tax on contributions made under a nonqualifying plan, provided the beneficiary's rights are forfeitable.

Subsequent to the taxable years here involved, Congress enacted a carefully limited scheme permitting tax incentives for retirement plans for the self-employed.[44] While the status of a plan in effect in 1961, 1962 and 1963 cannot be affected by radiations from a statute enacted four years later, we think the Court should be apprised of the differences. The 1967 statute applies only to income a self-employed person has first reduced to possession, and it allows him a deduction if he pays it over to a trustee in the taxable year. It eliminates nothing from his gross income, unlike Sections 402(a) and 402(b), but allows him a deduction. The fact that Congress has allowed this deduction from income has no tendency to suggest it would wish taxpayers taxed on income subject to forfeiture.

Within the context of this case, the most significant fact in measuring the Congressional purpose in adopting the 1954 Code is that Sections 401-404, inclusive, are more detailed versions of Sec. 165 of the 1939 Code, and the provisions deferring the tax on beneficiaries of both qualified and nonqualified plans now found in Sections 402(a) and 402(b) are taken virtually verbatim from the former [1939 Code] Sections 165(b) and 165(c). The entire 1954 Code is an elaborate and painstaking work and reflects intensive Congressional thought in formulation, drafting and adoption. The decisions on which we rely in *Schaefer v. Bowers, supra,* 50 F. 2d 689; *Julian Robertson, supra,* 6 T.C. 1060; and *Harold Perkins, supra,* 8 T.C. 1051, were decided in

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44. Under Pub. Law 90-607, changes adding to Sections 401(c) and (d) to the Code were made effective after Dec. 31, 1967.

1931, 1946 and 1947, respectively. The acquiescences in the latter two were published in 1946 and 1947, respectively, and the *Schaefer* case approved a Government argument. Congress must be assumed to have been aware of these decisions and of the administrative position the acquiescences represented. (Cf. *Commissioner v. LoBue*, 351 U.S. 243, 249 (1956).) It must have known that the new statute with its similar definition of gross income would be understood to mean the same as the old, and receive the same administrative construction, unless Congress modified it where it wanted the new statutes to be different.[45] Neither in Sec. 61 nor elsewhere has Congress shown a purpose to have the new Code be different from the old insofar as inclusion of forfeitable property in income is concerned, whereas in Sec. 402(b) it has expressly stated its purpose to continue to defer tax on forfeitable contributions to a nonqualifying plan.

The charge that the decision below opens the door to wholesale partnership plans which avoid the restrictions placed on the self-employed is a loose one. In going to the extraordinary extent of permitting the self-employed to place some of their fully earned and received gross income in a retirement trust and obtain a deduction for so doing, Congress naturally imposed restrictions. Those restrictions would have no place in a plan where the self-employed has unearned rights not yet ripened into gross income.

The practical answer is that by its nature this plan is extraordinary. It is part of an over-all scheme whereby a

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45. We do not contend that these judicial and administrative precedents tie this Court's hands under the re-enactment doctrine [cf. *Higgins v. Commissioner*, 312 U.S. 212, 215-216 (1941)]; our contention is that an inference of lack of Congressional concern over the probable continuation of prior interpretations is permissible. Congress would have legislated in some manner to represent a change if it had wished to confine all deferred compensation to employee cases.

partnership and a client mutually contemplate exclusivity for more than fifteen years, to promote the client's purpose, not that of the partnership. It is difficult to think of a parallel likely to occur in legal, medical or other professional practice.

Perhaps the closest parallel to this case is the insurance general agent, and he is a numerous example. Yet, the Commissioner has agreed that he should enjoy deferment of retirement income. Rev. Rul. 60-31, 1960-1 Cum. Bull. 174, 180, acquiescing in *James F. Oates*, 18 T.C. 570, affirmed sub nom. *Commissioner v. Oates*, 207 F. 2d 711 (C.A. 7, 1953), cited, *supra*.

If any threat to the revenue does exist, the defense to it does not lie in taxing the earner on contributions which are forfeitable and which he may never enjoy, but instead in statutes patterned after 1954 Code Section 404(a)(5)[46] which would deny the employer deductions for contributions to a nonqualifying plan for independent contractors until such time as the beneficiary becomes taxable. There would be no need to legislate taxability of the investment income of the trust fund since that is presently taxable, as in the present case. Injustice to taxpayers whose claims to future benefits are contingent and forfeitable is not only an inappropriate method of protecting the revenue, but is not the one which Congress adopted when it acted to curb the threat posed by nonqualified employee retirement plans.

In weighing the impact of a decision for the taxpayers on other plans, now in effect or created in the future, the Court may properly consider the circumstances making this case unique, even though not disclosed by the record. Full consideration must be given to the fact that the Health Plan, Kaiser, was tax-exempt. As a tax exempt organization, it

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46. Section 404(a)(5) was amended in 1969. The amendment was not retroactive in effect and does not apply to the tax years involved herein.

was not concerned that the payments to a nonqualified plan would not be deductible. An industrial or commercial employer, however, would not place itself in this position. It would not establish a non-qualified plan because its payments to such a plan could not be deducted for tax purposes.

CONCLUSION

The decision of the Court of Appeals is correct and should be affirmed.

Respectfully submitted,

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(Appendix follows)

Appendix

1939 Internal Revenue Code (Title 26 U.S.C.) Section 22(a)—Gross Income—Definition—

GENERAL DEFINITION.—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. In the case of Presidents of the United States and judges of courts of the United States taking office after June 6, 1932, the compensation received as such shall be included in gross income; and all Acts fixing the compensation of such Presidents and judges are hereby amended accordingly. In the case of judges of courts of the United States who took office on or before June 6, 1932, the compensation received as such shall be included in gross income.

[The 1954 Internal Revenue Code Sections and Regulations thereunder appear as in effect during the years 1961-63.]

1954 Internal Revenue Code (Title 26 U.S.C.) Section 61(a)—Gross Income Defined—

GENERAL DEFINITION.—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;

(2) Gross income derived from business;
(3) Gains derived from dealings in property;
(4) Interest;
(5) Rents;
(6) Royalties;
(7) Dividends;
(8) Alimony and separate maintenance payments;
(9) Annuities;
(10) Income from life insurance and endowment contracts;
(11) Pensions;
(12) Income from discharge of indebtedness;
(13) Distributive share of partnership gross income;
(14) Income in respect of a decedent; and
(15) Income from an interest in an estate or trust.

1954 Internal Revenue Code (Title 26 U.S.C.) Section 402(b)—Taxability of Beneficiary of Employees' Trust—

TAXABILITY OF BENEFICIARY OF NON-EXEMPT TRUST.—Contributions to an employees' trust made by an employer during a taxable year of the employer which ends within or with a taxable year of the trust for which the trust is not exempt from tax under section 501 (a) shall be included in the gross income of an employee for the taxable year in which the contribution is made to the trust in the case of an employee whose beneficial interest in such contribution is nonforfeitable at the time the contribution is made. The amount actually distributed or made available to any distributee by any such trust shall be taxable to him, in the year in which so distributed or made available, under section 72 (relating to annuities), except that section 72(e) (3) shall not apply.

1954 Internal Revenue Code (Title 26 U.S.C.) Section 404(a)(5)—

Deduction for Contributions of an Employer to an Employees' Trust or Annuity Plan and Compensation Under a Deferred-Payment Plan.—

(a) GENERAL RULE.—If contributions are paid by an employer to or under a stock bonus, pension, profit-sharing, or

annuity plan, or if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such contributions or compensation shall not be deductible under section 162 (relating to trade or business expenses) or section 212 (relating to expenses for the production of income); but, if they satisfy the conditions of either of such sections, they shall be deductible under this section, subject, however, to the following limitations as to the amounts deductible in any year:

. . . .

(5) OTHER PLANS.—In the taxable year when paid, if the plan is not one included in paragraph (1), (2), or (3), if the employees' rights to or derived from such employer's contribution or such compensation are nonforfeitable at the time the contribution or compensation is paid.

1954 Internal Revenue Code (Title 26 U.S.C.) Section 701—Partners, Not Partnership, Subject To Tax.

A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.

1954 Internal Revenue Code (Title 26 U.S.C.) Section 702—Income And Credits of Partner.

(a) GENERAL RULE.—In determining his income tax, each partner shall take into account separately his distributive share of the partnership's—

(1) gains and losses from sales or exchanges of capital assets held for not more than 6 months,

(2) gains and losses from sales or exchanges of capital assets held for more than 6 months,

(3) gains and losses from sales or exchanges of property described in section 1231 (relating to certain property used in a trade or business and involuntary conversions),

(4) charitable contributions (as defined in section 170 (c)),

(5) dividends with respect to which there is provided an exclusion under section 116, or a deduction under part VIII of subchapter B,

(6) taxes, described in section 901, paid or accrued to foreign countries and to possessions of the United States,

(7) partially tax-exempt interest on obligations of the United States or on obligations of instrumentalities of the United States as described in section 35 or section 242 (but, if the partnership elects to amortize the premiums on bonds as provided in section 171, the amount received on such obligations shall be reduced by the reduction provided under section 171 (a) (3)),

(8) other items of income, gain, loss, deduction, or credit, to the extent provided by regulations prescribed by the Secretary or his delegate, and

(9) taxable income or loss, exclusive of items requiring separate computation under other paragraphs of this subsection.

(b) CHARACTER OF ITEMS CONSTITUTING DISTRIBUTIVE SHARE.—The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under paragraphs (1) through (8) of subsection (a) shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.

(c) GROSS INCOME OF A PARTNER.—In any case where it is necessary to determine the gross income of a partner for purposes of this title, such amount shall include his distributive share of the gross income of the partnership.

1954 Internal Revenue Code (Title 26 U.S.C.) Section 703(a)—Partnership Computations.—

INCOME AND DEDUCTIONS.—The taxable income of a partnership shall be computed in the same manner as in the case of an individual except that—

(1) the items described in section 702 (a) shall be separately stated, and

(2) the following deductions shall not be allowed to the partnership:

(A) the standard deduction provided in section 141,

(B) the deductions for personal exemptions provided in section 151,

(C) the deduction for taxes provided in section 164 (a) with respect to taxes, described in section 901, paid or accrued to foreign countries and to possessions of the United States,

(D) the deduction for charitable contributions provided in section 170,

(E) the net operating loss deduction provided in section 172, and

(F) the additional itemized deductions for individuals provided in part VII of subchapter B (sec. 211 and following).

1954 Internal Revenue Code (Title 26 U.S.C.) Section 704 (a) and (b)—Partner's Distributive Share.—

(a) EFFECT OF PARTNERSHIP AGREEMENT.—A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this section, be determined by the partnership agreement.

(b) DISTRIBUTIVE SHARE DETERMINED BY INCOME OR LOSS RATIO.—A partner's distributive share of any item of income, gain, loss, deduction, or credit shall be determined in accordance with his distributive share of taxable income

or loss of the partnership, as described in section 702 (a) (9), for the taxable year, if—

(1) the partnership agreement does not provide as to the partner's distributive share of such item, or

(2) the principal purpose of any provision in the partnership agreement with respect to the partner's distributive share of such item is the avoidance or evasion of any tax imposed by this subtitle.

1954 Internal Revenue Code (Title 26 U.S.C.) Section 761(c)—Terms Defined—

PARTNERSHIP AGREEMENT.—For purposes of this subchapter, a partnership agreement includes any modifications of the partnership agreement made prior to, or at, the time prescribed by law for the filing of the partnership return for the taxable year (not including extensions) which are agreed to by all the partners, or which are adopted in such other manner as may be provided by the partnership agreement.

Treas. Reg. (26 C.F.R.) Section 1.61—2(d)(5)—Gross income—

Property transferred subject to restrictions. Notwithstanding any other provision of this paragraph, with respect to any property, other than an option to purchase stock or property, which is transferred by an employer to an employee or independent contractor as compensation for services, and which is subject to a restriction which has a significant effect on its value, the rules of paragraph (d) (2) of § 1.421-6 shall be applied in determining the time and the amount of compensation to be included in the gross income of the employee or independent contractor. For special rules relating to options to purchase stock or other property which are issued as compensation for services, see § 1.61-15 and section 421 and the regulations thereunder. This subparagraph is applicable only to transfers after September 24, 1959.

Treas. Reg. (26 C.F.R.) Section 1.402(b)—1(a)(1) and (2)(i)—

EMPLOYEE PLANS.—Treatment of beneficiary of a trust not exempt under section 501(a).—(a) *Taxation by reason of employer contributions.* (1) Except as provided in section 402(d), any contribution made by an employer on behalf of an employee to a trust during a taxable year of the employer which ends within or with a taxable year of the trust for which the trust is not exempt under section 501(a), shall be included in income of the employee for his taxable year during which the contribution is made if the employee's beneficial interest in the contribution is nonforfeitable at the time the contribution is made. If the employee's beneficial interest in the contribution is forfeitable at the time the contribution is made even though his interest becomes nonforfeitable later, the amount of such contribution is not required to be included in the income of the employee at the time his interest becomes nonforfeitable.

(2)(i) An employee's beneficial interest in the contribution is nonforfeitable within the meaning of sections 402(b), 403(b), 403(c), and 404(a)(5) at the time contribution is made if there is no contingency under the plan which may cause the employee to lose his rights in the contribution. Similarly, an employee's rights under an annuity contract purchased for him by his employer change from forfeitable to nonforfeitable rights within the meaning of section 403(d) at that time when, for the first time, there is no contingency which may cause the employee to lose his rights under the contract.

Treas. Reg. (26 C.F.R.) Accounting Methods—

§ 1.451-2. Constructive receipt of income.

(a) *General rule.* Income although not actually reduced to a taxpayer's possession is constructively received

by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

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In the Supreme Court of the United States

OCTOBER TERM, 1972

No. 71-1022

UNITED STATES OF AMERICA, *Petitioner*

vs.

JAMES A. BASYE and EVELYN E. BASYE, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

Amicus Curiae Brief In Support Of Respondents

IDENTIFICATION OF AMICUS CURIAE AND STATEMENT OF INTEREST

Kaiser Foundation Health Plan, Inc. ("Health Plan") is a California nonprofit corporation that operates a prepaid hospital and medical care program in Northern California as well as in other regions of the United States. The Internal Revenue Service has ruled that Health Plan is exempt from taxation under Section 501(c)(4) of the Internal Revenue

Code of 1954. Today the Health Plan serves more than 2,400,000 people. At the time of the events giving rise to this action it was serving more than 900,000 individuals.

The ultimate objective of the retirement plan that is the focus of this controversy was to insure that Health Plan, by offering an attractive retirement income to long-service physicians associated with The Permanente Medical Group ("Medical Group"), would have a stable and reliable group of physicians to provide medical services to Health Plan members. Obviously Health Plan's objective will be frustrated if setting aside funds to provide this deferred retirement income results in a current tax to the physicians.

Counsel for the parties in this matter have given their consents to the filing of this brief, and their letters advising of their consent are filed herewith.

STATEMENT OF FACTS

Health Plan contracts to arrange comprehensive medical and hospital care for its members. To fulfill this responsibility to its 390,000 members in its Northern California Region, Health Plan entered into an agreement effective as of July 1, 1959, with a partnership of physicians, Medical Group, under which Medical Group agreed to provide medical services for Health Plan members in Northern California. This agreement reflected the contemplated establishment of a retirement plan for all physicians associated with Medical Group, whether the individual physician was an employee or a partner.

In December 1959 the retirement plan was established as contemplated, and thereafter Health Plan made payments to the trust which was created for this retirement plan. The payments into this trust give rise to the controversy here.

The primary purpose of the retirement plan was to create an incentive for physicians to remain with the Medical Group, or other groups of physicians contracting to serve Health Plan members, and thus insure Health Plan that it

would have a stable and reliable group of physicians providing medical services to its members with a minimum of turn-over, whether the services were performed in Northern California or other areas in which it serves members. The retirement plan was patterned after one which had been established in Southern California between Health Plan and a partnership of physicians serving Health Plan members there. The payments, the taxation of which is in question here, would not have been paid by Health Plan except for the purpose of funding the retirement plan. (R. 83-84).

To serve its primary purpose, the retirement plan provides that the physicians supplying services to Health Plan members may receive benefits only upon fulfilling conditions of continuous service for a minimum period of time with the Medical Group or another medical group serving Health Plan members. Thus, Dr. Nadia Sorokowski, one of the respondents herein, forfeited her rights in September of 1963 when she terminated her membership in the Medical Group and did not become associated with another medical group serving Health Plan members. During the taxable years 1960, 1961, 1962 and 1963, there had been credited to Dr. Sorokowski's tentative account in the trust an aggregate amount of $6,797.32, which, upon her withdrawal from the partnership, was forfeited by her and reallocated to the tentative accounts of the then participants in the retirement plan. The Government would tax Dr. Sorokowski in each of the years mentioned on the amounts credited to her tentative account despite the fact that she never had a right to receive these payments, never did receive them, and never will receive them. (R. 87).

Further, a participant will forfeit his benefits after having become eligible to receive them if he renders professional services for a competitor of Health Plan or if, while able to do so, he refuses to render consulting services to Health Plan or to its affiliates.

Finally, if the Medical Group is dissolved or reorganized, and if at least 50% of the participants in the retirement plan reassociate with the new group or with another group serving Health Plan members, the trust fund remains intact and unretired participants who do not join the new group forfeit the amounts tentatively credited to their accounts. Thus no individual participant, whether an employee or a partner, has anything more than a conditional and tentative interest in amounts credited to his account. It is, moreover, entirely possible that none of the persons who were partners or employees of Medical Group in any year in which a payment is made will ever receive any portion of such payment.

SUMMARY OF ARGUMENT

The Government seeks to tax respondents currently on amounts they have not received, never have had the power to receive and may never receive. In response we have four main points.

1. *Lucas v. Earl*, 281 U.S. 111 (1930), holds that tax liability cannot be shifted by an anticipatory assignment of income. This principle applies only where, but for the assignment, the assignor would have had power to receive the income. The doctrine of *Lucas v. Earl* is not applicable here because it is stipulated that the contributions to the trust were not otherwise available to Medical Group or to its individual members or employees. This Court recently observed that "... the assignment-of-income doctrine assumes that the income would have been received by the taxpayer had he not arranged for it to be paid to another ..." *Commissioner v. First Security Bank of Utah*, 405 U.S. 394, 404 (1972). The essential point is that the amounts involved here never were in the control of Medical Group or any physician, and neither Medical Group nor any physician ever had the power to arrange for them to be paid to another.

1. The contributions to the trust conferred upon the participants mere contingent and forfeitable claims which under long-standing authority do not constitute income taxable currently. *Schaefer v. Bowers*, 50 F.2d 689 (C.A. 2, 1931), *cert. den.* 284 U.S. 668; *Harold Perkins*, 8 T.C. 1051 (1947), *acq.* 1947-2 Cum. Bul. 3; *Julian Robertson*, 6 T.C. 1060 (1946), *acq.* 1946-2 Cum. Bul. 4. The Government acquiesced in two of these cases and won the third.

2. The case is no different because respondents do business as partners rather than as sole proprietors. Since the inception of the income tax, partners have been taxed as individuals. This principle was recognized and confirmed by this Court in *Neuberger v. Commissioner*, 311 U.S. 83 (1940). The contingent and forfeitable nature of the contributions to the trust is not affected by the manner in which respondents chose to do business.

3. Affirmance here will not open the doors to subversion of the statutory scheme relating to qualified deferred compensation plans, and will not open the doors to tax avoidance. Qualified plans confer substantially greater tax benefit than the benefits which are claimed here by reason of the principle of cases which have stood without challenge for decades, that the contingent and forfeitable rights of participants in the retirement plan are not taxable currently. The unique facts of this case, moreover, that the entire structure of the plan was designed to benefit Health Plan and to treat employees and partners equally, that the contributions in question were "not otherwise available" to respondents and that further service to Health Plan was required to vest benefits in any individual, all distinguish this case from the case of a taxpayer who takes the initiative in sponsoring a deferred compensation plan, rather than acting as a mere agent contracting on behalf of certain individuals.

ARGUMENT

I. Lucas v. Earl Does Not Apply.

The principle of *Lucas v. Earl*, 281 U.S. 111 (1930), is that the tax on an amount that would otherwise be taxable cannot be avoided by an anticipatory arrangement initiated by the party otherwise entitled to the amount. That is, if the natural flow of income is thus interrupted and diverted to another through the exercise of dominion and control over it, for tax purposes the diversion is ignored. Application of the principle is premised on a finding or assumption that, *but for* the anticipatory arrangement, the assignor could have received income.

We have no quarrel with *Lucas v. Earl*, but this is not a *Lucas v. Earl* case. Here, the contributions were made to the trust not because Medical Group desired it, but because Health Plan, the source of the funds, would not have it otherwise. The parties stipulated (R. 83-84):

> "The primary purpose of the retirement plan was to create an incentive for physicians to remain with Medical Group, or other groups of physicians contracting to serve Health Plan members, and thus to insure Health Plan that it would have a stable and reliable group of physicians providing medical services to its members with a minimum of turn-over. The retirement plan was patterned after one previously established in Southern California between Health Plan and a partnership of physicians serving Health Plan members in its Southern California Region. The payments which Health Plan agreed to, and did make to the trust, were paid *solely to fund the retirement plan, and were not otherwise available to Medical Group or to the individual members or employees thereof.*" [Emphasis added]

Thus, in this case neither the taxpayers nor Medical Group had any right to a payment over which it could exercise

dominion or control, nor did it have the right to receive any payment. Accordingly, the principles enunciated in *Lucas v. Earl* can have no application. As this Court said in *Commissioner v. First Security Bank of Utah*, 405 U.S. 394, 403-404 (1972):

> "In cases dealing with the concept of income, it has been assumed that the person to whom the income was attributed could have received it. The underlying assumption always has been that in order to be taxed for income, a taxpayer must have complete dominion over it. 'The income that is subject to a man's unfettered command that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not.' *Corliss v. Bowers*, 281 US 376, 378 (1930).
>
> "It is, of course, well established that income assigned before it is received is nonetheless taxable to the assignor. But the assignment-of-income doctrine assumes that the income would have been received by the taxpayer had he not arranged for it to be paid to another...."

The Government suggests (Pet. Br. 13) that this case is not different from *Lucas v. Earl* because in neither case did the taxpayer have the right to receive the payments in question. However, this analysis ignores the fact that in *Lucas v. Earl* the barrier to receipt of the funds was self-imposed by the party otherwise entitled to them, and that *but for* the anticipatory assignment the amounts there involved clearly would have been income taxable to him. In this case neither Medical Group nor any physician had the right, present or prospective, to receive the amounts in question except as they become payable under the terms of the retirement plan.

Whether the Health Plan-Medical Group retirement arrangement and the payments thereunder gave rise to cur-

rently taxable income obviously is the ultimate issue, but it is not a *Lucas v. Earl* issue. Rather, it is an issue to be resolved according to general principles relating to realization of income that we discuss below. If application of these principles should produce the conclusion that there is a realization of income here, then the income is currently taxable for that reason, not because of *Lucas v. Earl*. If, on the other hand, there is no item that would have been such income in the absence of an anticipatory arrangement, as we maintain, then the *Lucas v. Earl* principle never is reached, because as stated this principle is premised on a finding or assumption that, *but for* the anticipatory arrangement, the assignor could and would have received income. There was no assignment here; because nothing could have been received, nothing could have been assigned.

II. The Payments In Question Do Not Constitute Currently Taxable Income.

Whether there was current income has two aspects, namely (1) whether the amounts in question were available to Medical Group or to any physician other than through the retirement plan, and (2) if not, whether contributions to the trust nevertheless represent current income to the respondents. We will discuss these two questions in order.

A. The first question was settled by the stipulation, already referred to, that Health Plan's contributions to the trust were ". . . paid solely to fund the retirement plan, and were not otherwise available to Medical Group or to the individual members or employees thereof." (R. 84). Neither Medical Group nor any individual physician had any right to increased current compensation in exchange for decreased contributions to the retirement trust. As has been stipulated, the Health Plan's contributions to the trust were available in the form offered or not at all. The absence of

the right to receive these amounts was not a constraint self-imposed by the party sought to be taxed, as it was in *Lucas v. Earl*, but rather a constraint imposed by Health Plan in order to serve Health Plan's purposes.

B. The rights of any participant in the trust contributions are contingent and forfeitable until the very moment they are paid out in the form of retirement benefits. There are three cases holding that forfeitable and contingent contributions such as these do not produce current income. *Schaefer v. Bowers*, 50 F.2d 689 (C.A. 2, 1931), *cert. den.* 284 U.S. 668; *Harold Perkins*, 8 T.C. 1051 (1947), *acq.* 1947-2 Cum. Bul. 3; *Julian Robertson*, 6 T.C. 1060 (1946), *acq.* 1946-2 Cum. Bul. 4. The Government did not contend in the Court of Appeals that these cases were incorrectly decided (Pet. 37), nor does it make that contention here; it simply dismisses these cases as irrelevant (Pet. Br. 22). They are irrelevant, the Government suggests, because the contracting party is a partnership rather than one or more individuals, an asserted basis for distinction that is incorrect, as we discuss below.

For present purposes we would only emphasize that these cases, in which the Government has acquiesced,[1] establish that nothing would be taxed to any individual here had no partnership existed. Under *Schaefer*, *Robertson* and *Perkins*, nothing has been received or is receivable and there is nothing that attains the status of "income", whether the question is viewed as being statutory or governed by general legal principles established by the courts relating to the realization of income.

There is no question but that the contributions to the trust were intended as additional compensation for ser-

1. The acquiescences were in *Robertson* and *Perkins*, which are Tax Court cases. *Schaefer* is a Second Circuit case that the Government won.

vices, but the Government errs (Br. 7) in speaking of these contributions as compensation for services "of the partnership". The Health Plan agrees with the principle that "income must be taxed to him who earns it", but here the retirement benefits have not been earned by Medical Group, but will ultimately be earned by those individual physicians who serve Health Plan members over a long period of years, whether or not they continue their association with Medical Group.

The Health Plan had good business reasons for establishing a deferred compensation plan for physicians as an important feature of its nonprofit, community-service health care program. (R. 83-84). At the same time, tax consequences are seldom a matter of indifference, and there obviously would have been no value in Health Plan's sponsoring a retirement plan if it were to mean ruinous tax consequences for the physicians to whom it was intended to appeal as an economic incentive.

The only authorities that were available to Health Plan regarding the probable tax consequences of the retirement plan it had in mind were the cases discussed above. They are not Supreme Court cases, but their holdings are compatible with the concept of income as it has been developed by this Court since 1913.[2] The Government tacitly acknowledged as much when it acquiesced in them a quarter of a century ago.

III. Partners Are Taxed as Individuals.

Since the inception of the income tax, partners have been taxed as individuals. Subchapter K of the Internal Revenue

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2. For example: "In cases dealing with the concept of income, it has been assumed that the person to whom the income was attributed could have received it." *Commissioner v. First Security Bank of Utah*, 405 U.S. 394, 403 (1972).

Code deals with partners and partnerships and begins with Section 701:

> "A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities."

Partners do not incur income tax liability that they would not incur as sole proprietors in similar circumstances, and *Schaefer, Perkins* and *Robertson* are no less available to respondents as partners than they would be to respondents as sole proprietors.

In *Neuberger v. Commissioner*, 311 U.S. 83 (1940), this Court permitted a partner to offset his share of partnership profits from securities sales against his individual securities losses, just as if he had executed all his securities transactions in his individual capacity. *Neuberger* resolved a conflict between *Johnston v. Commissioner*, 86 F.2d 732 (C.A. 2, 1936), and *Craik v. United States*, 31 F. Supp. 132 (Ct. Cl. 1940). In *Neuberger* this Court approved *Craik*, which involved a nonresident alien who was a member of two American partnerships that derived a portion of their income from sources outside the United States. The statute provided that the gross income of a nonresident alien included only income from sources within the United States. The Court concluded that the amounts in question were not gross income to taxpayer because it was "... convinced that Congress intended that partnership income should be treated as though it had been received by the partners individually." *Craik v. United States*, 31 F. Supp. 132, 135.[3]

The Government has frequently relied upon and received the benefit of the principle of *Craik* and *Neuberger*. See

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3. The Internal Revenue Service has ruled that the effect of *Neuberger* was to affirm *Craik*. Rev. Rul. 55-415, 1955-1 C.B. 412.

Lief J. Sverdrup, 14 T.C. 859 (1950); *Foster v. United States*, 329 F.2d 717 (C.A. 2, 1964); *Randolph Products Co. v. Manning*, 176 F.2d 190 (C.A. 3, 1949); *Commissioner v. Paley*, 232 F.2d 915 (C.A. 9, 1956), *cert. den.* 352 U.S. 838; *Commissioner v. Ammann*, 228 F.2d 417 (C.A. 5, 1955); and *A. A. Emmerson*, (1965) 44 T.C. 86.

The Government nevertheless purports to dismiss *Schaefer*, *Robertson* and *Perkins* by its assertion that the *partnership* was "irrevocably compensated" by Health Plan's contribution to the trust (Pet. Br. 22). This assertion ignores the forfeitable nature of the partners' interest in the contributions, ignores the partnership's inability to exercise control over the contributions, and ignores the possibility that no partner or employee whose services were allegedly "irrevocably compensated" by a given contribution may ever receive any portion of such contribution. Thus, the Government here asks this Court to tax respondents currently solely because they elected to conduct their affairs as partners rather than as individuals.

IV. The Decision Below Does Not Permit Circumvention of the Limitations Upon Qualified Pension Trusts.

The Government suggests that affirmance would invite wholesale circumvention of the statutory requirements for obtaining the benefits of qualified deferred compensation plans. This is not so.

This case involves the application of principles established by *Schaefer*, *Robertson* and *Perkins*. These decisions have been accepted and presumably applied in the administration of our income tax for many years. They are based upon the concept that a mere right which is contingent and forfeitable, thus being completely dependent upon future events, cannot rise to the status of taxable income. It is ludicrous for the Government to argue now that they pre-

not a serious threat to revenue, particularly when the Government has acquiesced in two of these decisions and won the third with the argument made here.

The qualified pension trusts which are provided for in Section 401 of the Internal Revenue Code of 1954 confer substantially greater benefits than does the retirement plan here. Thus in a qualified pension trust the tax is deferred even if the employee's interest is fully vested and non-forfeitable. Regulations § 1.402(a)-1(a)(1)(i). The Government does not explain how the statutory scheme is frustrated by a plan that provides significantly lesser benefits than those available under a qualified plan. We do not see how it is.

Finally, the Government's concern that partnerships of any size and in any business may establish similar plans to avoid tax on whatever portion of their compensation they choose to defer (Pet. Br. 24) ignores a set of facts probably unique to this case. Health Plan was responsible for health care over a wide geographic area, and required a stable pool of experienced physicians to serve that whole area. To meet that requirement, they offered deferred and forfeitable compensation to individuals, whether partners or employees, and whether or not those individuals maintained a relationship with Medical Group, so long as they maintained a relationship with Health Plan. This deferred and forfeitable compensation was "not otherwise available", and the Medical Group could not change the form in which it was offered. The facts of this case present the rare situation where a partnership acts as a mere agent, implementing a deferred compensation plan which is designed to assure the long-term services of individuals for the payor. Affirmance here can hardly affect many other situations, and will certainly open no doors to tax avoidance.

CONCLUSION

There is no question of income escaping taxation in this case. It is recognized by all concerned that Health Plan's contributions are to be subjected to income tax at some time. The question here is whether the contributions should be taxed currently to Medical Group partners, as the Government demands, or later, to retired participants, on the sums actually distributed to them from the trust.

Respectfully submitted,

GEORGE E. LINK
Attorney for Kaiser Foundation Health Plan, Inc., Amicus Curiae

October 2, 1972

In the Supreme Court of the United States

OCTOBER TERM, 1972

No. 71-1022

UNITED STATES OF AMERICA, PETITIONER

v.

JAMES A. BASYE AND EVELYN E. BASYE, ET AL.

WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

1. Respondents persist in arguing a case that is not before the Court. They devote the first part of their argument (Br. 13-26) to demonstrating that contingent beneficiaries of the trust should not, as such, be liable on payments from the trust that they may not receive. As we pointed out in our principal brief (p. 7), the Government "has not sought, and does not rely, to support its assessments against the partners [on the ground] they were contingent beneficiaries." In the notices of deficiencies (R. 13-19, 24-30), deficiencies were asserted against partners in Medical Group because partnership income was increased by amounts which were compensation for partnership services although paid to the trust. Since this was additional partnership income, the partners were liable for tax on their distributive shares of the increased partnership income. (R. 18, 19, 29, 30.)

466-060—72

If the partnership had deflected its compensation to persons other than partners, or to a trust for persons other than partners, that compensation would still have constituted partnership income. *Lucas* v. *Earl*, 281 U.S. 111; *Hogle* v. *Commissioner*, 132 F. 2d 66 (C.A. 10); *Effler* v. *Commissioner*, 29 B.T.A. 784. The fact that the partners were, in large part, contingent beneficiaries of the trust to which compensation was deflected can hardly reduce or defer the partnership income resulting from the payment of that compensation. Cf. *Magibow* v. *Commissioner*, 218 F. 2d 687 (C.A. 3). There was nothing contingent or uncertain about Health Plan's payments of compensation for Medical Group's services. Over $2,000,000 was paid in cash to the trust during the years 1960–1963. As respondents acknowledge (Br. 4), none of this amount was to be, or ever was, repayable to Health Plan.

2. Respondents would turn exactly in reverse the tax treatment of partnership income provided by every revenue act since 1913 when they state (Br. 31) that partnership income consists only of the aggregate of partners' income, computed without reference to the partnership.[1] Sections 701–704 of the Internal Revenue Code of 1954 require, as every preceding income tax statute has required, that partnership income be first computed (Sec. 703), and that each partner take into income his distributive, or proportionate, share thereof. (Secs. 702 and 704.) No substantive change was made by dropping the phrase "whether or not distribution is made to him," which appeared in Section

[1] Since the partnership pays no tax, there would be no reason to compute partnership income if respondents were correct.

182 of the Internal Revenue Code of 1939.' 6 Mertens, *Law of Federal Income Taxation* (Rev.), Sec. 35.29. Perhaps the most explicit illustration of the relationship between a partner's taxable income and partnership taxable income is the fact that a cash basis partner must nevertheless take into his income his distributive share of accrued partnership income if the partnership has elected the accrual method of accounting. 6 Mertens, *supra*, Sec. 35.61.

Respondents seek to find support in this Court's decision in *Neuberger* v. *Commissioner*, 311 U.S. 83; but that decision has little relevance to this case. It dealt only with the question whether the character of an item of partnership income (income from the sale of securities) was reflected in the partners' shares of distributive income, one of the questions of characterization of income now dealt with in detail by Section 702 and the regulations thereunder. Here we have no question of characterization of income, or of any special treatment afforded by the Code to income of a certain character. Compensation for services, the income here involved, is ordinary income to a partnership, and ordinary income to a partner. It falls within the residuary or catchall provision of Section 702(a)(9). To the extent that the *Neuberger* decision has relevance here, it supports our position in that its very point of departure is that each partner must take into his income his proportionate share of part-

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* "Under your committee's bill, as under existing law, partners will be liable individually for income tax on their distributive shares of partnership income." H. Rep. No. 1337, 83d Cong., 2d Sess., p. 65. See also S. Rep. No. 1622, 83d Cong., 2d Sess., p. 89.

nership income. That is true whether distribution is made, is not made, or can not be made. *Heiner* v. *Mellon*, 304 U.S. 271.

3. As we have pointed out, this case rests upon two decisions of this Court, each fundamental in the field of income taxation. First, compensation for services constitutes taxable income and must be taxed to him who earns it; the tax cannot be avoided by anticipatory arrangements and contracts however skillfully devised. *Lucas* v. *Earl*, 281 U.S. 111. The payments of compensation for Medical Group's services were therefore taxable income to the Medical Group partnership, even though deflected to a trust, just as they would have been taxable to the partnership if they had been deflected to the partners' wives, or any one else. Second, partners must take into income their distributive, or proportionate, shares of partnership income, whether or not that income is or can be distributed. *Heiner* v. *Mellon*, 304 U.S. 271. The respondents were therefore required to take into their income their proportionate shares of Medical Group's taxable income because they were partners, not because of any relationship they may or may not have had to the trust to which Medical Group's compensation was deflected. Cf. *Griffiths* v. *Commissioner*, 308 U.S. 355, 357.

Respectfully submitted.

ERWIN N. GRISWOLD,
Solicitor General.

DECEMBER 1972.

U.S. GOVERNMENT PRINTING OFFICE: 1972

NOTE: Where it is deemed desirable, a syllabus (headnote) will be released, as is being done in connection with this case, at the time the opinion is issued. The syllabus constitutes no part of the opinion of the Court but has been prepared by the Reporter of Decisions for the convenience of the reader. See *United States* v. *Detroit Lumber Co.*, 200 U.S. 321, 337.

SUPREME COURT OF THE UNITED STATES

Syllabus

UNITED STATES *v.* BASYE ET AL.

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

No. 71-1022. Argued December 11, 1972—
Decided February 27, 1973

A medical partnership (Permanente), in which respondent physicians were partners, made an agreement to supply medical services to members of a health foundation (Kaiser). A portion of Kaiser's compensation to Permanente was in the form of payments into a retirement trust for the benefit of Permanente's physicians, none of whom was eligible to receive the amounts in his tentative account prior to retirement after specified years of service. No interest in the account was deemed to vest in a particular beneficiary before retirement, and a physician's preretirement severance from Permanente would occasion the forfeiture of his interest, with redistribution to the remaining participants. Under no circumstances, however, could Kaiser recoup the payments once made. The Commissioner of Internal Revenue assessed a deficiency against each partner-respondent for his distributive share of the amount paid by Kaiser, which he had not reported as taxable income. In this refund suit the District Court, with the Court of Appeals affirming, held that the payments to the fund were not income to the partnership because it did not receive and had no "right to receive" them. *Held:* The retirement fund payments, notwithstanding the fact that they were contributed directly to the trust, were compensation for services that Permanente rendered under the medical-service agreement and should have been reported as income to Permanente; and the individual partners should have included their shares of that income in their individual returns, since the existence of conditions upon the actual receipt by a partner of income fully earned by the partnership is not a relevant factor in determining its taxability to him. Pp. 7-16.

450 F. 2d 109, reversed and remanded.

POWELL, J., delivered the opinion of the Court, in which BURGER, C. J., and BRENNAN, STEWART, WHITE, MARSHALL, BLACKMUN, and REHNQUIST, JJ., joined. DOUGLAS, J., dissented.

NOTICE: This opinion is subject to formal revision before publication in the preliminary print of the United States Reports. Readers are requested to notify the Reporter of Decisions, Supreme Court of the United States, Washington, D.C. 20543, of any typographical or other formal errors, in order that corrections may be made before the preliminary print goes to press.

SUPREME COURT OF THE UNITED STATES

No. 71-1022

United States, Petitioner, v. James A. Basye et al.	On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

[February 27, 1973]

MR. JUSTICE POWELL delivered the opinion of the Court.

This is a partnership income tax case brought here by the United States on a petition for writ of certiorari from the Court of Appeals for the Ninth Circuit. Respondents, physicians and partners in a medical partnership, filed suit in the District Court for the Northern District of California seeking the refund of income taxes previously paid pursuant to a deficiency assessed by the Commissioner of Internal Revenue. The case was heard on an agreed statement of facts and the District Court ruled in respondents' favor. 295 F. Supp. 1289 (1968). The Government appealed to the Ninth Circuit and that court affirmed the lower court's judgment. 450 F. 2d 109 (1971). We agreed to hear this case to consider whether, as the Government contends, the decision below is in conflict with precedents of this Court. 405 U. S. 1039 (1972). Because we find that the decision is incompatible with basic principles of income taxation as developed in our prior cases, we reverse.

I

Respondents, each of whom is a physician,[1] are partners in a limited partnership known as Permanente

[1] Technically, the married respondents' spouses are also parties because they filed joint income tax returns for the years in question

Medical Group, which was organized in California in 1949. Associated with the partnership are over 200 physician-partners, as well as numerous nonpartner physicians and other employees. In 1959, Permanente entered into an agreement with Kaiser Foundation Health Plan, Inc., a nonprofit corporation providing prepaid medical care and hospital services to its dues-paying members.

Pursuant to the terms of the agreement, Permanente agreed to supply medical services for the 390,000 member-families, or about 900,000 individuals, in Kaiser's Northern California Region which covers primarily the San Francisco Bay area. In exchange for those services, Kaiser agreed to pay the partnership a "base compensation" comprised of two elements. First, Kaiser undertook to pay directly to the partnership a sum each month computed on the basis of the total number of members enrolled in the health program. That number was multiplied by a stated fee, which originally was set at a little over $2.60. The second item of compensation—and the one that has occasioned the present dispute—called for the creation of a program, funded entirely by Kaiser, to pay retirement benefits to Permanente's partner and nonpartner physicians.

The pertinent compensation provision of the agreement did not itself establish the details of the retirement program; it simply obligated Kaiser to make contributions to such a program in the event that the parties might thereafter agree to adopt one.[2] As might be ex-

here. Any references to respondents in this opinion, however, refers only to the physician-partners.

[2] The pertinent portion of the Kaiser-Permanente medical service contract states:

"Article II

"*Base Compensation to Medical Group*

"As base compensation to [Permanente] for Medical Services to

pected, a separate trust agreement establishing the contemplated plan soon was executed by Permanente, Kaiser, and the Bank of America Trust and Savings Association, acting as trustee. Under this agreement Kaiser agreed to make payments to the trust at a predetermined rate, initially pegged at 12 cents per health plan member per month. Additionally, Kaiser made a flat payment of $200,000 to start the fund and agreed that its pro rata payment obligation would be retroactive to the date of the signing of the medical service agreement.

The beneficiaries of the trust were all partners and nonpartner physicians who had completed at least two years of continuous service with the partnership and who elected to participate. The trust maintained a separate tentative account for each beneficiary. As periodic payments were received from Kaiser, the funds were allocated among these accounts pursuant to a complicated formula designed to take into consideration on a relative basis each participant's compensation level, length of service, and age. No physician was eligible to receive the amounts in his tentative account prior to retirement, and retirement established entitlement only if the participant had rendered at least 15 years of continuous service or 10 years of continuous service and had attained age 65. Prior to such time, however, the trust agreement explicitly provided that no interest in any tentative ac-

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be provided by [Permanente] hereunder, [Kaiser] shall pay to [Permanente] the amounts specified in this Article H.

. . . . . .

"*Section H–4. Provision for Savings and Retirement Program for Physicians.*

"In the event that [Permanente] establishes a savings and retirement plan or other deferred compensation plan approved by [Kaiser], [Kaiser] will pay, in addition to all other sums payable by [Kaiser] under this Agreement, the contributions required under such plan to the extent that such contributions exceed amounts, if any, contributed by Physicians . . . ."

count was to be regarded as having vested in any particular beneficiary.[3] The agreement also provided for the forfeiture of any physician's interest and its redistribution among the remaining participants if he were to terminate his relationship with Permanente prior to retirement.[4] A similar forfeiture and redistribution also would occur if, after retirement, a physician were to render professional services for any hospital or health plan other than one operated by Kaiser. The trust agreement further stipulated that a retired physician's right to receive benefits would cease if he were to refuse any reasonable request to render consultative services to any Kaiser operated health plan.

The agreement provided that the plan would continue irrespective either of changes in the partnership's personnel or of alterations in its organisational structure. The plan would survive any reorganization of the partnership so long as at least 50% of the plan's participants remained associated with the reorganized entity. In the event of dissolution or of a nonqualifying reorganization, all of the amounts in the trust were to be divided among the participants entitled thereto in amounts governed by each participant's tentative account. Under no circumstances, however, could payments from Kaiser to the trust be recouped by Kaiser: once compensation was

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[3] The trust agreement states:

"The tentative accounts and suspended tentative accounts provided for Participants hereunder are solely for the purpose of facilitating record keeping and necessary computations, and confer no rights in the trust fund upon the individuals for whom they are established. . . ."

[4] If, however, termination were occasioned by death or permanent disability, the trust agreement provided for receipt of such amounts as had accumulated in that physician's tentative account. Additionally, if, after his termination for reasons of disability prior to retirement, a physician should reassociate with some affiliated medical group his rights as a participant would not be forfeited.

paid into the trust it was thereafter committed exclusively to the benefit of Permanente's participating physicians.

Upon the retirement of any partner or eligible nonpartner physician, if he had satisfied each of the requirements for participation, the amount that had accumulated in his tentative account over the years would be applied to the purchase of a retirement income contract. While the program thus provided obvious benefits to Permanente's physicians, it also served Kaiser's interests. By providing attractive deferred benefits for Permanente's staff of professionals, the retirement plan was designed to "create an incentive" for physicians to remain with Permanente and thus "insure" that Kaiser would have a "stable and reliable group of physicians." [4]

During the years from the plan's inception until its discontinuance in 1963, Kaiser paid a total of more than $2,000,000 into the trust. Permanente, however, did not report these payments as income in its partnership returns. Nor did the individual partners include these payments in the computations of their distributive shares of the partnership's taxable income. The Commissioner assessed deficiencies against each partner-respondent for his distributive share of the amount paid by Kaiser. Respondents, after paying the assessments under protest, filed these consolidated suits for refund.

The Commissioner premised his assessment on the conclusion that Kaiser's payments to the trust constituted a form of compensation to the partnership for the

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[4] The agreed statement of facts filed by the parties in the District Court states:

"The primary purpose of the retirement plan was to create an incentive for physicians to remain with [Permanente] . . . and thus to insure [Kaiser] that it would have a stable and reliable group of physicians providing medical services to its members with a minimum of turn-over. . . ."

services it rendered and therefore was income to the partnership. And, notwithstanding the deflection of those payments to the retirement trust and their current unavailability to the partners, the partners were still taxable on their distributive shares of that compensation. Both the District Court and the Court of Appeals disagreed. They held that the payments to the fund were not income to the partnership because it did not receive them and never had a "right to receive" them. 295 F. Supp., at 1292–1294; 450 F. 2d, at 114–115. They reasoned that the partnership, as an entity, should be disregarded and that each partner should be treated simply as a potential beneficiary of his tentative share of the retirement fund.[5] Viewed in this light, no presently taxable income could be attributed to these cash basis[6] taxpayers because of the contingent and forfeitable nature of the fund allocations. 295 F. Supp., at 1294–1296; 450 F. 2d, at 112.

We hold that the courts below erred and that respondents were properly taxable on the partnership's retirement fund income. This conclusion rests on two familiar principles of income taxation, first, that income is taxed to the party who earns it and that liability may not be avoided through an anticipatory assignment of that income, and, second, that partners are taxable on

[5] The Court of Appeals purported not to decide, as the District Court had, whether the partnership should be viewed as an "entity" or as a "conduit." 450 F. 2d, at 113 n. 5 and 115. Yet its analysis indicates that it found it proper to disregard the partnership as a separate entity. After explaining its view that Permanente never had a right to receive the payments, the Court of Appeals stated: "When the transaction is viewed in this light, the partnership becomes a mere *agent* contracting on behalf of its members for payments to the trust for their ultimate benefit, rather than a *principal* which itself realizes taxable income." *Id.*, at 115 (emphasis supplied).

[6] Each respondent reported his income for the years in question on the cash basis. The partnership reported its taxable receipts under the accrual method.

their distributive or proportionate shares of current partnership income irrespective of whether that income is actually distributed to them. The ensuing discussion is simply an application of those principles to the facts of the present case.

II

Section 703 of the Internal Revenue Code of 1954, insofar as pertinent here, prescribes that "[t]he taxable income of a partnership shall be computed in the same manner as in the case of an individual." 26 U. S. C. § 703 (a). Thus, while the partnership itself pays no taxes, 26 U. S. C. § 701, it must report the income it generates and such income must be calculated in largely the same manner as an individual computes his personal income. For this purpose, then, the partnership is regarded as an independently recognizable entity apart from the aggregate of its partners. Once its income is ascertained and reported, its existence may be disregarded since each partner must pay a portion of the total income as if the partnership were merely an agent or conduit through which the income passed.[8]

[8] There has been a great deal of discussion in the briefs and in the lower court opinions with respect to whether a partnership is to be viewed as an "entity" or as a "conduit." We find ourselves in agreement with the Solicitor General's remark during oral argument when he suggested that "[i]t seems odd that we should still be discussing such things in 1972." Tr. of Oral Arg., at 14. The legislative history indicates, and the commentators agree, that partnerships are entities for purposes of calculating and filing informational returns but that they are conduits through which the tax-paying obligation passes to the individual partners in accord with their distributive shares. See, *e. g.*, H. R. Rep. No. 1337, 83d Cong., 2d Sess., 65-66 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess., 89-90 (1954); 6 J. Mertens, Law of Federal Income Taxation § 35.01 (1968); S. Surrey & W. Warren, Federal Income Taxation 1115–1116 (1960); Jackson, Johnson, Surrey, Tenen & Warren, The Internal Revenue Code of 1954: Partnerships, 54 Col. L. Rev. 1183 (1954).

In determining any partner's income it is first necessary to compute the gross income of the partnership. One of the major sources of gross income, as defined in § 61 (a)(1) of the Code, is "compensation for services, including fees, commissions, and similar items." 26 U. S. C. § 61 (a)(1). There can be no question that Kaiser's payments to the retirement trust were compensation for services rendered by the partnership under the medical service agreement. These payments constituted an integral part of the employment arrangement. The agreement itself called for two forms of "base compensation" to be paid in exchange for services rendered—direct per-member, per-month payments to the partnership and other, similarly computed, payments to the trust. Nor was the receipt of these payments contingent upon any condition other than continuation of the contractual relationship and the performance of the prescribed medical services. Payments to the trust, much like the direct payments to the partnership, were not forfeitable by the partnership or recoverable by Kaiser upon the happening of any contingency.

Yet the courts below, focusing on the fact that the retirement fund payments were never actually received by the partnership but were contributed directly to the trust, found that the payments were not includable as income in the partnership's returns. The view of tax accountability upon which this conclusion rests is incompatible with a foundational rule, which this Court has described as "the first principle of income taxation: that income must be taxed to him who earns it." *Commissioner* v. *Culbertson*, 337 U. S. 733, 739–740 (1949). The entity earning the income—whether a partnership or an individual taxpayer—cannot avoid taxation by entering into a contractual arrangement whereby that income is diverted to some other person or entity. Such arrangements, known to the tax law as "anticipatory assign-

ments of income," have frequently been held ineffective as means of avoiding tax liability. The seminal precedent, written over 40 years ago, is Mr. Justice Holmes' opinion for a unanimous Court in *Lucas* v. *Earl*, 281 U. S. 111 (1930). There the taxpayer entered into a contract with his wife whereby she became entitled to one-half of any income he might earn in the future. On the belief that a taxpayer was accountable only for income actually received by him, the husband thereafter reported only half of his income. The Court, unwilling to accept that a reasonable construction of the tax laws permitted such easy deflection of income tax liability, held that the taxpayer was responsible for the entire amount of his income.

The basis for the Court's ruling is explicit and controls the case before us today:

> "[T]his case is not to be decided by attenuated subtleties. It turns on the import and reasonable construction of the taxing act. There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skilfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew." *Id.*, at 114–115.

The principle of *Lucas* v. *Earl*, that he who earns income may not avoid taxation through anticipatory arrangements no matter how clever or subtle, has been repeatedly invoked by this Court and stands today as a cornerstone of our graduated income tax system. See, *e. g.*, *Commissioner* v. *Harmon*, 323 U. S. 44 (1944);

United States v. *Joliet & Chicago R. Co.*, 315 U. S. 44 (1942); *Helvering* v. *Eubank*, 311 U. S. 122 (1940); *Burnet* v. *Leininger*, 285 U. S. 136 (1932). And, of course, that principle applies with equal force in assessing partnership income.

Permanente's agreement with Kaiser, whereby a portion of the partnership compensation was deflected to the retirement fund, is certainly within the ambit of *Lucas* v. *Earl*. The partnership earned the income and, as a result of arms' length bargaining with Kaiser,[9] was responsible for its diversion into the trust fund. The Court of Appeals found the *Lucas* principle inapplicable because Permanente "never had the right itself to receive the payments made into the trust as current income." 450 F. 2d, at 114. In support of this assertion, the court relied on language in the agreed statement of facts stipulating that "the payments . . . were paid solely to fund the retirement plan, and were not otherwise available to [Permanente] . . . ." *Ibid.* Emphasizing that the fund was created to serve Kaiser's interest in a stable source of qualified, experienced physicians,[10] the court found that Permanente could not have received that income except in the form in which it was received.

The court's reasoning seems to be that, before the partnership could be found to have received income, there must be proof that "Permanente agreed to accept less direct compensation from Kaiser in exchange for the retirement plan payments." *Id.*, at 114–115. Apart from the inherent difficulty of adducing such evidence, we know of no authority imposing this burden upon the Government. Nor do we believe that the guiding principle of *Lucas* v. *Earl* may be so easily circumvented.

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[9] The agreed statement of facts states that the contracting parties were "separate organizations independently contracting with one another at arms' length."

[10] See n. 5, *supra*.

Kaiser's motives for making payments are irrelevant to the determination whether those amounts may fairly be viewed as compensation for services rendered.[11] Neither does Kaiser's apparent insistence upon payment to the trust deprive the agreed contributions of their character as compensation. The Government need not prove that the taxpayer had complete and unrestricted power to designate the manner and form in which his income is received. We may assume, especially in view of the relatively unfavorable tax status of self-employed persons with respect to the tax treatment of retirement plans,[12] that many partnerships would eagerly accept conditions similar to those prescribed by this trust in consideration for tax deferral benefits of the sort suggested here. We think it clear, however, that the tax laws permit no such easy road to tax avoidance or defer-

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[11] Respondents do not contend that such payments were gifts or some other type of nontaxable contribution. See *Commissioner* v. *LoBue*, 351 U. S. 243 (1956); *Bingler* v. *Johnson*, 394 U. S. 741 (1969).

[12] Disparities have long existed between the tax treatment of pension plans for corporate employees and the treatment of similar plans for the self-employed and for members of partnerships. S. Surrey & W. Warren, *supra* n. 8, at 598–599. In 1962 Congress endeavored to ameliorate these differences by enacting corrective legislation, Pub. L. No. 87-792, 76 Stat. 809 (1962). While that legislation, commonly known as H. R. 10 or the Jenkins-Keogh Bill, provided some relief, it fell far short of affording a parity of treatment for professionals and other self-employed individuals. Internal Revenue Code of 1954, § 404. For a detailed review of the intricate provisions of the applicable statute and for a close comparison of the present differences see Grayck, Tax Qualified Retirement Plans for Professional Practitioners: A Comparison of the Self-Employed Individuals Tax Requirement Act of 1962 and the Professional Association, 63 Col. L. Rev. 415 (1963); Note, Federal Tax Policy and Retirement Benefits—A New Approach, 59 Geo. L. J. 1299 (1971); Note, Tax Parity for Self-Employed Retirement Plans, 58 Va. L. Rev. 338 (1972).

ment." Despite the novelty and ingenuity of this arrangement, Permanente's "base compensation" in the form of payments to a retirement fund was income to the partnership and should have been reported as such.

III

Since the retirement fund payments should have been reported as income to the partnership, along with other income received from Kaiser, the individual partners should have included their shares of that income in their individual returns. 26 U. S. C. §§ 61 (a)(13), 702, 704. For it is axiomatic that each partner must pay taxes on his distributive share of the partnership's income without regard to whether that amount is actually distributed to him. *Heiner* v. *Mellon*, 304 U. S. 271 (1938), decided under a predecessor to the current partnership provisions of the Code,[14] articulates the salient proposi-

[14] Respondents contend in this Court that this case is controlled by *Commissioner* v. *First Security Bank of Utah*, 405 U. S. 394 (1972), decided last Term. We held there that the Commissioner could not properly allocate income to one of a controlled group of corporations under 26 U. S. C. § 482 where that corporation could not have received that income as a matter of law. The "assignment-of-income doctrine" could have no application in that peculiar circumstance because the taxpayer had no legal right to receive the income in question. *Id.*, at 403–404. In essence, that case involved a deflection of income imposed by law, not an assignment arrived at by the consensual agreement of two parties acting at arms' length as we have in the present case. See n. 5, *supra*.

[15] Revenue Act of 1918, c. 18, § 218 (a), 40 Stat. 1057:

"There shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year . . ."

Other predecessor statutes contained similar explicit indications that a partner's distributive share was to be computed without reference to actual distribution. See Income Tax Act of 1913, c. 16, § II, D, 38 Stat. 168, 169 ("whether divided or otherwise"); Internal Revenue Code of 1939, c. 289, § 182, 53 Stat. 521 ("whether or not distribution

tion. After concluding that "distributive" share means the "proportionate" share as determined by the partnership agreement, *id.*, at 280, the Court stated:

> "[t]he tax is thus imposed upon the partner's proportionate share of the net income of the partnership, and the fact that it may not be currently distributable, whether by agreement of the parties or by operation of law, is not material." *Id.*, at 281.

Few principles of partnership taxation are more firmly established than this one that no matter the reason for nondistribution each partner must pay taxes on his distributive share. Treas. Reg. § 1.702–1 (1956).[10] See, *e. g.*, *Hulbert* v. *Commissioner*, 227 F. 2d 399 (CA7 1955); *Bell* v. *Commissioner*, 219 F. 2d 442 (CA5 1955); *Stewart* v. *United States*, 263 F. Supp. 451 (SDNY 1967); *Freudman* v. *Commissioner*, 10 T. C. 775 (1948); S. Surrey & W. Warren, Federal Income Taxation 1115 (1960); 6 J. Mertens, Law of Federal Income Taxation §§ 35.01, 35.22 (1968); A. Willis, On Partnership Taxation § 5.01 (1971).

The courts below reasoned to the contrary, holding that the partners here were not properly taxable on the amounts contributed to the retirement fund. This view, apparently, was based on the assumption that each partner's distributive share prior to retirement was too contingent and unascertainable to constitute presently recognizable income. It is true that no partner knew with

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is made to him"). Nothing in the legislative history suggests that any substantive change was intended by the deletion of this phrase from the 1954 Code revisions. See H. R. Rep. No. 1337, 83d Cong., 2d Sess., 65 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess., 89 (1954).

[10] The regulation states as follows:

"Each partner is required to take into account separately in his return his distributive share, whether or not distributed, of each class or item of partnership income. . . ."

certainty exactly how much he would ultimately receive or whether he would in fact be entitled to receive anything. But the existence of conditions upon the actual receipt by a partner of income fully earned by the partnership is irrelevant in determining the amount of tax due from him. The fact that the courts below placed such emphasis on this factor suggests the basic misapprehension under which they labored in this case. Rather than being viewed as responsible contributors to the partnership's total income, respondent-partners were seen only as contingent beneficiaries of the trust. In some measure this misplaced focus on the considerations of uncertainty and forfeitability may be a consequence of the erroneous manner in which the Commissioner originally assessed the partners' deficiencies. The Commissioner divided Kaiser's trust fund payments into two categories: (1) payments earmarked for the tentative accounts of *nonpartner*-physicians; and (2) those allotted to *partner*-physicians. The payments to the trust for the former category of nonpartner physicians were correctly counted as income to the partners in accord with the distributive share formula as established in the partnership agreement.[9] The latter payments to the tentative accounts of the individual partners, however, were improperly allocated to each partner pursuant to the complex formula in the retirement plan itself, just as if that agreement operated as an amendment to the partnership agreement. 295 F. Supp., at 1292.

The Solicitor General, alluding to this miscomputation during oral argument, suggested that this error "may be what threw the court below off the track." [10] It should

[9] These amounts would be divided equally among the partners pursuant to the partnership agreement's stipulation that all income above each partner's drawing account "shall be distributed equally."

[10] Tr. of Oral Arg., at 13–14. As the Solicitor General has also pointed out, the parties have, by stipulation in their agreed state-

be clear that the contingent and unascertainable nature of each partner's share under the retirement trust is irrelevant to the computation of his distributive share. The partnership had received as income a definite sum which was not subject to diminution or forfeiture. Only its ultimate disposition among the employees and partners remained uncertain. For purposes of income tax computation it made no difference that some partners might have elected not to participate in the retirement program or that, for any number of reasons, they might not ultimately receive any of the trust's benefits. Indeed, as the Government suggests, the result would be quite the same if the "potential beneficiaries included no partners at all, but were children, relatives, or other objects of the partnership's largesse." [18] The sole operative consideration is that the income had been received by the partnership, not what disposition might have been effected once the funds were received.

IV

In summary, we find this case controlled by familiar and long settled principles of income and partnership taxation. There being no doubt about the character

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ment of facts, foreseen that recomputations might be necessary in light of the ultimate resolution of this controversy and have taken precautions to assure that any necessary reallocations may be handled expeditiously. Agreed Statement of Facts, ¶ 24, App., at 87–88.

[18] Petitioner's Brief, at 21. For this reason the cases relied on by the Court of Appeals, 450 F. 2d, at 113, which have held that payments made into deferred compensation programs having contingent and forfeitable features are not taxable until received, are inapposite. *Schaefer* v. *Bowers*, 50 F. 2d 689 (CA2 1931); *Harold G. Perkins*, 8 T. C. 1031 (1947); *Julian Robertson*, 6 T. C. 1060 (1946). Indeed, the Government notes, possibly as a consequence of these cases, that the Commissioner has not sought to tax the *nonpartner*-physicians on their contingent accounts under the retirement plan. Petitioner's Brief, at 21.

of the payments as compensation, or about their actual receipt, the partnership was obligated to report them as income presently received. Likewise, each partner was responsible for his distributive share of that income. We, therefore, reverse the judgments and remand the case with directions that judgments be entered for the United States.

It is so ordered.

MR. JUSTICE DOUGLAS dissents.

Table of Authorities Cited

Cases	Pages
Commissioner v. First Security Bank of Utah, 405 U.S. 394 (1972), 31 L.Ed.2d 318	3, 8
Lucas v. Earl, 281 U.S. 111	3, 8
Teschner v. Commissioner, 38 T.C. 1003 (1962)	3

Codes	
Internal Revenue Code of 1954, Section 701	8

In the Supreme Court
OF THE
United States

OCTOBER TERM 1972

No. 71-1022

UNITED STATES OF AMERICA,
Petitioner
vs.
JAMES A. BASYE and EVELYN E. BASYE, et al.,
Respondents

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

RESPONDENTS' PETITION FOR REHEARING

THIS COURT'S DECISION IS CONTRARY TO THE STIPULATED FACTS.

Petitioners request a rehearing on the ground that the Court has failed to accept as true certain stipulated facts, facts which if believed require a decision in respondents' favor.

The case was presented to the District Court on an Agreed Statement of Facts. For that reason there was no trial of any fact issue. The only disputes ever presented for judicial resolution were questions of law. Both lower courts resolved the case in respondents' favor on the stipulated facts.

This Court has now reversed, not because of any disagreement with the legal principles applied below, but because of a failure to accept as true paragraph 16 of the Agreed Statement. That paragraph reads as follows:

> The primary purpose of the retirement plan was to create an incentive for physicians to remain with Medical Group, or other groups of physicians contracting to serve Health Plan members, and thus to insure Health Plan that it would have a stable and reliable group of physicians providing medical services to its members with a minimum of turn-over. The retirement plan was patterned after one previously established in Southern California between Health Plan and a partnership of physicians serving Health Plan members in its Southern California Region. *The payments which Health Plan agreed to, and did make to the trust, were paid solely to fund the retirement plan, and were not otherwise available to Medical Group or to the individual members or employees thereof.* (Italics supplied.)[1]

Both lower courts understood the Agreed Statement to mean that the retirement plan was not established by the

[1]Paragraph 16 must, of course, be read in its full context as part of the entire Agreed Statement of Facts, including paragraph 13 which states that the plan ". . . was not unilaterally established by Medical Group," and paragraph 15, which states that ". . . Health Plan and Medical Group were separate organizations independently contracting with one another at arms' length." (Appendix on Writ of Certiorari, pp. 80-88.)

Medical Group partnership with funds over which it had any control; that had the Medical Group partnership elected not to agree to the retirement plan, it would not have received any additional current income; and that it did not agree to accept less direct compensation in exchange for these retirement plan payments.

The stipulation established, we had thought plainly and unequivocally, that the Kaiser Health Plan made these funds available on its own terms or not at all; that is, although the partnership might have refused to participate in the plan, such a refusal would not have increased its current income in any degree whatsoever. The stipulation *negated*, by agreement of the parties, what is surely an essential predicate of a *Lucas v. Earl* assignment, namely, that the "assignor" have exercised *some* degree of legal or economic power to accomplish a deflection of income from his account to that of another. This control concept was recently reaffirmed by this Court in *Commissioner v. First Security Bank of Utah*, 405 U.S. 394 (1972), 31 L.Ed.2d 318, 326, as follows:

> In cases dealing with the concept of income, it has been assumed that the person to whom the income was attributed could have received it. The underlying assumption always has been that in order to be taxed for income, a taxpayer must have complete dominion over it.[2]

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[2]The Court also approved *Teschner v. Commissioner*, 38 T.C. 1003, 1009 (1962) which expressly held that the exercise of a power to designate the recipient of income is not alone sufficient to give rise to the application of the *Lucas v. Earl* doctrine (31 L.Ed.2d 318, 328, fn. 22). A *fortiori* Medical Group's mere consent to the establishment of this Retirement Plan to be funded by Health Plan with funds completely beyond Medical Group's control, was not sufficient.

The opinion of this Court does not purport to alter or modify that principle. Rather, it is based on a different view of the facts, as if the Court were unwilling to believe that the facts as stipulated were actually true. Thus, the opinion says:

> The Court of Appeals found the *Lucas* principle inapplicable because Permanente "never had the right itself to receive the payments made into the trust as current income." 450 F.2d at 114. In support of this *assertion*, the court relied on language in the agreed statement of facts stipulating that "the payments . . . were paid solely to fund the retirement plan, and were not otherwise available to [Permanente]. . . ." *Ibid.* Emphasizing that the fund was created to serve Kaiser's interest in a stable source of qualified, experienced physicians, the court *found* that Permanente could not have received that income except in the form in which it was received.
>
> The court's reasoning seems to be that, before the partnership could be found to have received income, there must be proof that "Permanente agreed to accept less direct compensation from Kaiser in exchange for the retirement plan payments." *Id.*, at 114-115. *Apart from the inherent difficulty of adducing such evidence, we know of no authority imposing this burden upon the Government.* (Italics supplied.)
>
> (Opinion, p. 10)

At this point in its opinion, the Court fundamentally misconceives the facts stipulated, and the entire decision hinges on that misconception. The Court of Appeals did not impose upon the government the burden of proving that Permanente agreed to accept less direct compensation in exchange for the retirement plan. Quite the con-

trary. The burden of proof on that issue—*i.e.*, that Permanente did *not* agree to accept less—was on respondents.[3]

That burden was met when the parties stipulated that the payments which Health Plan agreed to make into the plan *were not otherwise available*, because if Permanente had agreed to accept less direct compensation in exchange for the plan, such would have meant that the payments had been "otherwise" available, *i.e.*, in the form of direct compensation. Evidence establishing that agreed fact would have been presented if the issue had been tried.[4]

The case should be viewed as if that issue of fact had been tried, as if that evidence had been presented at the trial, and as if the District Court had then adopted the "Agreed Statement of Facts" as its findings in respondents' favor. Yet the decision of this Court is the same as if the issue had been tried and respondents had lost.[5] The ultimate effect is to deny respondents their day in court.

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[3]Any "difficulty in adducing evidence" on this issue was a part of respondents' burden, not the government's. The issue, of course, was "whether or not" Permanente agreed to accept less direct compensation in exchange for the retirement plan. If the government had the burden of proof—which it did not—it would have been to prove that Permanente *had* agreed to accept less. If the respondents had the burden of proof—which they did—it was to prove that Permanente *had not* agreed to accept less. In stating that ". . . there was no evidence that Permanente agreed to accept less . . . ," the Court of Appeals was merely expressing its understanding that the issue was resolved by the Agreed Statement.

[4]See Certificate of Counsel, Appendix, p. iii.

[5]The Court characterizes as "found" by, or as an "assertion" of, the Court of Appeals, the facts which that court *by reason of the stipulation* accepted as true. In a similar vein, the Court refers to *Kaiser's* "apparent" insistence upon payment to the trust, as if it were not bona fide and *real*. (Opinion, p. 11.)

Paragraph 16 was included in the Agreed Statement for the specific purpose of establishing that this was *not* a case in which the Medical Group partnership had exercised the power to deflect to the retirement plan (thus deferring until a later year) compensation which it might otherwise have received currently. Respondents' counsel were well aware that if such were the fact, the payments would be held to constitute partnership income. Because that issue could not be resolved by reference to the terms of the written instruments alone, respondents had requested a jury trial in the District Court. The terms of the Agreed Statement were arrived at only after weeks of discussion. Paragraph 16 was proposed by respondents' counsel as an alternative to a trial of that issue. It was agreed to by the government's attorneys only after extensive discovery, with full knowledge of its implications, and in the belief that if was better to stipulate the fact than to try the issue and lose.

We have said that this Court appears unwilling to believe that the facts as stipulated were true. Perhaps it is, rather, that the stipulation has been misinterpreted on this point. At the oral argument, Mr. Justice Rehnquist suggested that the "not otherwise available" language meant merely that *after* the money was placed in trust it was beyond the control of the Medical Group partnership (Transcript of Oral Argument, at p. 24). If that were all it meant, then of course, the Court's decision would be correct. But it was intended to mean that *before* the payments were made, at the very time they were agreed to be made, Medical Group had no control over those funds.

Thus the sentence reads, "The payments which Health Plan *agreed to*, and did make . . . were not otherwise available."[6]

Respondents' counsel has at every stage of this case, in the District Court, in the Court of Appeals, and in this Court, consistently maintained that interpretation of the stipulation. It has *never* been challenged by *any* government lawyer, *including* the lawyer who negotiated, on behalf of the government, the terms of the stipulation.[7]

It is particularly distressing, in the light of this history and after two eminent lower courts have believed and adhered to the stipulation according to the original intention of the parties, to find that the Supreme Court of the United States has decided the case by disbelieving or misunderstanding the facts which the stipulation resolved. Respondents have no quarrel with the legal principles upon which the Court has based its decision. If the facts were as the Court mistakenly took them to be—if the Medical Group (like the hypothetical Ropes & Cromwell firm) had agreed to place in this trust compensation which it could have enjoyed as current income, then the Court

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[6] As can be seen from the Certificate of Counsel, Appendix, p. ii, this portion of the stipulation was not necessary to establish that *after* the payments went into trust they were beyond control of the partnership. The trust documents cover that, and the government attorneys had from the beginning been willing to stipulate that all the terms of the retirement plan were integrated in the writings.

[7] If the government's counsel now wish to question that interpretation—and we do not think that they do—we hereby offer to rescind the stipulation so that the case may be remanded for a trial of that issue.

is correct: such would have been current income to the partnership under the principle of *Lucas v. Earl*.[3]

We also have no quarrel with the Court's concern about schemes for tax avoidance. But that concern cannot justify sweeping away a legitimate arrangement based on a unique set of relationships not likely ever to be duplicated elsewhere. If the opinion stands, a large number of people will have to pay taxes on "income" over which neither the partnership nor they ever had any control, and which, due to the forfeiture provisions of this retirement plan, they will never receive.

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[3]At the oral argument, the Solicitor General posed three hypothetical cases, involving the law firm of Ropes & Cromwell and its client, International Conglomerates. Each example was based on the fact that:

> In the past, Ropes & Cromwell has billed at appropriate intervals and these have been paid. Now let us suppose that . . . *hereafter ten percent of the bill* be paid to the law firm's retirement fund. (Transcript of Oral Argument, at 16-17.) (Italics Supplied)

The Solicitor General did not put a case in which the law firm continued to be paid 100% of its bills, the payments into the fund being in addition thereto, in which it would not have received anything more for its services had no such payments been made. When that distinction was exposed by the Court's questioning, respondents' counsel seemed unwilling to concede that "in the Solicitor General's hypothetical case . . . the result would be other than the result you contend for in this case." (Transcript of Oral Argument, at 29-30.) Mr. Brookes' response, however, rested upon his view that Section 701 was controlling without regard to the distinction. In fact, respondents do concede that on the hypothetical facts put by the Solicitor General, the portion of Ropes & Cromwell's bill which was deflected to the retirement plan would be partnership income. But in the case at bar, there was no such deflection.

The distinction is critical and controls the result here unless this Court intends to broaden the *Lucas v. Earl* doctrine to include payments which it has been found (or which it has been stipulated) were "not otherwise available" to the taxpayer. Such would be a significant departure from the standard enunciated in the *First Security Bank of Utah* case, that *Lucas v. Earl* applies only where "the income would have been received by the taxpayer had he not arranged for it to be paid to another. . . ."

A rehearing should be granted. The decision should be vacated and a new decision entered based on the facts as stipulated, or at the very least, the matter should be remanded to the trial court for a hearing on the factual issue.

Respectfully submitted,

JOHN F. WELLS,

Attorney for Respondents and Petitioners.

STARK, STEWART, SIMON & SPARROWE,

Of Counsel.

March 21, 1973.

(Appendix Follows)

Appendix

Certificate of Counsel

I, John F. Wells, hereby certify that I am an attorney at law, licensed to practice in the State of California and admitted to practice before this Court. I am a partner in the law firm of Stark, Stewart, Simon & Sparrowe, 1200 Financial Center Building, Oakland, California 94612, attorneys for respondents in this case. I was the attorney with the primary responsibility for preparing and presenting the case in the District Court, and in the Court of Appeals. I was the principal author of the plaintiffs' brief in both lower courts, and I made the oral argument on behalf of plaintiffs in both lower courts. I prepared the respondents' brief in opposition to the petition for certiorari. After this Court granted certiorari, Mr. Valentine Brookes of San Francisco took over responsibility for the case, and I did not participate significantly in the preparation of the respondents' brief filed in this Court, nor in the oral argument, although I was present in Court and heard the oral argument on December 11, 1972. I have reviewed a transcript of that proceeding.

I hereby certify that the Petition for Rehearing filed herewith is presented in good faith and not for delay, based upon the following facts which are within my personal knowledge:

The original complaints in these cases were filed on December 12, 1965. Thereafter, Mr. John Youngquist, Assistant United States Attorney in San Francisco, conducted discovery proceedings on behalf of the government,

including depositions of key persons from the Permanente Medical Group and Kaiser Health Plan, and examination of all of the files, documents, correspondence, etc., which were deemed by the government's attorneys to be pertinent.

Upon completion of discovery, Mr. Youngquist indicated that he did not expect to raise any factual issues not covered by the written documents evidencing the retirement plan in question, and suggested that it ought to be possible to submit the case for decision on an agreed statement of facts. I was willing to try, and negotiations toward that end were conducted over a period of several months until the Agreed Statement of Facts in its present form was signed and filed on March 2, 1968.

The first proposed drafts of the Agreed Statement was prepared and submitted by Mr. Youngquist on October 6, 1967. It did not contain the subject matter of paragraph 16 of the Agreed Statement as filed. It did contain language, similar to that now found in paragraph 13, that "The Plan was fully integrated and embodied in a written agreement. . . ." It also stated that "It is agreed . . . that the provisions of the trust agreement are complete and that they define and control the rights of the parties to the agreement."

As counsel for plaintiffs, I was not satisfied that the Agreed Statement as proposed would be adequate because it omitted important facts regarding how the plan came into being, and because I was afraid that the Court might think that the plan had been created by the Medical Group partnership to be funded with money which was under its control. I knew this was not true and that the

evidence would prove the contrary. Accordingly, I suggested that we enter into a "Partial Agreed Statement" (and I drafted such a document), which would have allowed for a hearing at which evidence could be introduced on the unstipulated issue. At about the same time, I proposed as an alternative the inclusion in the Agreed Statement of the subject matter which ultimately became what is now paragraph 16. This was one of the last matters to be resolved. When Mr. Youngquist agreed to the inclusion in the stipulation of paragraph 16, I dropped my insistence on presenting oral testimony and having the trier of the fact decide that issue.

I would not have agreed to waive the right to a trial had I thought there was any possibility that the Agreed Statement of Facts would be disregarded or misinterpreted as this Court has now done. I would instead have insisted upon a trial of that fact issue. Among other things, the evidence would have shown—and this evidence is still available—that the amounts paid by Health Plan to fund the plan were arrived at by actuarial estimates of what would be necessary to achieve certain benefit levels, that because of differences among the various medical groups serving Health Plan (primarily in age distributions within the groups and past service) contribution rates differed. For example, the same plan was commenced in Southern California with a contribution rate of six cents per member per month, later increased to seven cents and then to nine cents, whereas the rate in Northern California was twelve cents per member per month. There was never any attempt to equalize this disparity.

At every stage of this proceeding, in the briefs and argument in the District Court, in the Court of Appeals, and in the Brief in Opposition to Petition for a Writ of Certiorari, I have always asserted that paragraph 16 of the Agreed Statement of Facts means that the Medical Group partnership never had any control over the funds that Kaiser Health Plan agreed to pay, and later did pay, into the retirement plan—that these funds were in addition to any income which it could have received currently, and that it never could or would have received these funds in any form other than as payments into this retirement plan. To my knowledge, that interpretation has never been challenged or questioned by any government lawyer at any stage of these proceedings, and so far as I know was accepted as correct by all participants in both lower courts. I know of nothing which has transpired since which should cause this Court to view the facts in any different way.

Under penalty of perjury, I declare that I have examined the above Certificate and to the best of my knowledge and belief it is true and correct.

JOHN F. WELLS

March 21, 1973.